Know When to Hold 'Em and Know When to Fold 'Em: Probate Litigation and Settlements Involving IRAs

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Introduction

- "Non-Probate Revolution"
- $9t in defined contribution plans and IRAs!
- IRA assets don't pass by Will or intestacy
- Disputes center on beneficiary designation forms
  - Owner lacked capacity;
  - Owner was unduly influenced; and/or
  - Technical defect in the form.
- This looks a lot like Will contests

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Introduction – Cautionary Tale 1

- *Ozimkoski v. Commissioner* - T.C. Memo 2016-228
  - Although spouse was not named beneficiary, bank erroneously deposited assets of late husband's IRA into her IRA; distributions from her IRA, including to decedent's son to settle probate dispute, were taxable to her and subject to penalties.
  - Court noted it was clear the spouse's <u>attorney failed to counsel her on the full tax ramifications</u>.

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Introduction – Cautionary Tale 2

- PLR 201623001
  - Participant named his son as sole beneficiary of his IRAs
  - Spouse claimed ½ was her community property
  - Pursuant to settlement agreement, state court ordered son to transfer large amount of inherited IRA to spouse
  - Income tax and penalties applied

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Introduction – Tax Problems?

- If a beneficiary designation is reformed, will it be respected by the IRS?
- If so, what tax benefits/detriments apply?
- The answers turn on minutia:
  - 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?
- Must know when to play each gambit

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Background – IRA Basics

- Talk focuses on IRAs
  - Similar to other retirement vehicles, but rules may differ
- IRAs are nonqualified plans (unlike 401(k)'s, etc.)
- Favorable tax treatment
  - Tax deferred until distributions made
  - "Legislative Grace"
    - The government giveth and the government taketh away!
- Not intended to preserve and transfer wealth
  - RMDs required when Owner reaches RBD

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Background – Key Terms & Concepts

- "**Plan**"
  - The IRA itself, including the rules under which it operates
- "**Owner**" (a/k/a "**Participant**")
  - Individual who initially sets up the IRA
- "**Beneficiary**"
  - Person who inherits an IRA
- Required Minimum Distribution ("**RMD**")
  - Amount that must be distributed from an IRA in a given year
  - Large penalties apply if RMDs not taken

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Background – Key Terms & Concepts

- Required Beginning Date ("**RBD**")
  - Date Owner must start taking RMDs
  - Generally, April 1 of the year after Owner reaches age 72 Retirement status didn't used to matter (but it does now)
- "**Stretch-Out**"
  - The ability to lengthen the time over which RMDs must be paid by a Beneficiary
    - Longer Stretch-Out generally means better tax result
  - Maximum Stretch-Out available is usually when RMDs can be calculated based on Beneficiary's life expectancy
  - Under SECURE, Stretch-Out generally 10yrs, with exceptions

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Background – Key Terms & Concepts

- Designated Beneficiary ("**DB**")
  - Subset of Beneficiaries
  - Entitled to some tax benefits
  - Generally, must be an individual
    - Trusts and estates are disqualified…usually
    - A class of individuals (i.e. the Owner's children) counts if class member with shortest life expectancy identifiable
  - May be designated by terms of the Plan or the beneficiary designation

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Background – Key Terms & Concepts

- 5-Year Rule ("**5YR**")
  - Default rule for non-DBs
  - Must take out all assets out by Dec. 31 of year containing 5th anniversary of Owner's death
- 10-Year Rule ("**10YR**")
  - Default rule for DBs
  - Must take out all assets out by Dec. 31 of year containing 10th anniversary of Owner's death

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Background – Key Terms & Concepts

- Eligible Designated Beneficiary ("**EDB**")
  - Subset of DBs created by SECURE
  - Entitled to more tax benefits than DB's
    - Distributions over someone's life rather than the 5YR or 10YR
    - Depends on the specific category
  - Categories:
    - Spouse
    - Minor Children (not grandchildren or other minors)
    - Disabled Beneficiary
    - Chronically Ill Individual
    - Less than 10 Years Younger Beneficiary

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Background – Key Terms & Concepts

- Beneficiary Finalization Date ("**BFD**")
  - Sept. 30 of year following Owner's death
  - Deadline for determining DBs and EDBs (we think)
  - Deadline for disclaiming IRA assets

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Background – RMDs for Beneficiaries

- Depends on:
  - Identification of Beneficiaries
  - Whether Owner survived RBD
  - Whether SECURE applies or not
    - Participants dying before January 1, 2020 (mostly)

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Tax Concepts – Legal Authority

- Internal Revenue Code of 1986 ("**IRC**")
  - Title 26 USC
- Case Law
  - SCOTUS
  - Circuit Courts of Appeals
  - Lower Courts
    - District Courts
    - The Tax Court (most authoritative)
    - The Court of Federal Claims

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Tax Concepts – Legal Authority

- Pronouncements
  - Treasury Regulations (under the IRC)
    - Proposed, temporary, or final
    - Not technically binding, but given great deference
  - Revenue Rulings and Procedures
    - Official IRS position
    - May be relied on
  - Private Letter Rulings ("**PLRs**"), Determination Letters, Technical Advice Memoranda, and Chief Counsel Advice
    - Guidance to specific taxpayer only
    - May not be relied on (except requesting taxpayer)
    - Can be very expensive

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Tax Concepts – Gift & Income Tax

- Do not assume litigation is not taxable
  - Settlements and court orders may trigger tax
- *Bona fide* disputes generally avoid tax, but
  - Sale or exchange treatment may still exist and trigger income tax
  - Sham treatment may apply to trigger transfer tax
  - Mere agreement to court order is not *bona fide* dispute
- "State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." -*Morgan v. Comm'r of Internal Revenue*

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Tax Concepts – The Problem:

- Child and Spouse (step-mother) survive Owner
- Child claims Spouse exerted undue influence over Owner, thereby inducing him to improperly name Spouse as a Beneficiary of $1mm IRA.
- Pursuant to a settlement agreement, an order is entered amending the beneficiary designation with retroactive effect, such that Souse and Child are each designated as ½ Beneficiaries.
- Assume order entered before BFD.
- What result?

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Tax Concepts – The Problem:

- Two Issues:
  1. Will the IRS respect the order?
     - If not, Spouse has distributed $500k from the IRA to herself AND THEN made a gift of that $500k to Child
       - Income tax on $500k distribution PLUS
       - Gift tax on $500k gift
     - This is a VERY bad result
  2. If the order is respected, are Spouse and Child DBs?
     - If so, they get to stretch out the RMDs
     - If not, does the 5YR apply?
     - Are Spouse and Child treated differently?

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Tax Concepts – The "Answer":

- We don't really know
  - Authority mixed on these issues (see below)
- We *think* the following:
  1. Order should be respected if dispute a *bona fide*
     - Spouse should at least get out of the income tax
       - No immediate distribution
       - Child picks up
       - BUT: Watch out for sale & exchange treatment
     - Hope that gift tax also will not apply
  2. IRS probably will not give DB status to Child
     - BUT: Spouse may be able to roll IRA assets over

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Tax Concepts – The "Answer":

- PLR 2007-42026
  - Beneficiary designation modified by state court order
  - Change allowed without transfer tax consequences
  - BUT new Beneficiaries not granted DB status.
  - See also 2007-07158
- BUT See PLR 2016-23001
  - Indicates that opposite result should apply
  - New PLRs in 2019 also had favorable results for spouses

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Tax Concepts – Disclaimers?

- Refusal to accept property by gift or inheritance
  - "**Disclaimant**" treated as if predeceased
  - No dispositive control over assets
- IRC § 2518 ("**Qualified Disclaimers**")
  - Must be made before Disclaimant receives any benefit from the disclaimed property
    - Rev. Rul. 2005-36. provides safe harbor excluding receipt of RMDs in the year of Owner's death as "any benefit"
  - BUT: Disclaimant may not receive any consideration
    - <u>Disclaimers therefore basically useless in settlements</u>
  - Note: Other rules apply as well

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Tips & Strategies

- Send Discovery Early to identify
  - Existence of IRA
  - Existing beneficiary designations
  - Previous beneficiary designations
  - Default plan provisions
- Remember BFD Deadline
- Don't rely on what people say!
  - Client, opposing party, plan administrator, etc...
  - Verify, verify, verify!

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Tips & Strategies

- OK to cut beneficiaries out
  - Example: Person NOT named in beneficiary designation agrees to NOT take any of the IRA
    - May get something else instead
  - Disclaimers may work here if no consideration
    - Just verifying that someone is not a beneficiary
  - Must be done before BFD
  - Includes "spoilers" such as trusts or charities
  - OK to cut by distributing a person's share
    - See *Treas. Reg. § 1.401(a)(9)-4, Q and A-4(a)*

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Tips & Strategies

- Investigate invalidating beneficiary designation
  - Undue influence
  - Lack of capacity
  - Technical defect
  - Breach of fiduciary duty/Self dealing
- Do old designations get revived?
  - We don't know

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Tips & Strategies

- Reformed beneficiary designation form
  - Should state that they're not a gift or exchange to avoid tax
    - Just clearing up everyone's understanding of what was proper
  - Give retroactive effect
  - BUT: Unlikely to get DB status
  - Surviving spouse may get favorable treatment
  - Reformation solely for tax purpose won't work
    - Collusion and sham rules
  - Consider making settlement contingent on favorable PLR
    - This will take a lot of time, though

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Tips & Strategies

- Disclaimers are of limited use
  - Consideration bar gets in the way
  - No dispositive control over assets

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Tips & Strategies

- No DB status for added Beneficiaries
  - Generally, "in order to be a designated beneficiary, an individual must be a beneficiary as of the date of death." - *Treas. Reg. § 1.401(a)(9)-4, Q and A-4.*
  - Note: This is for DB status, not other purposes
  - May be specifically named, or part of a class
  - May be default or explicit

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Tips and Strategies

- Make sure to advise the client on tax effects
  - Don't simply let clients waive tax advice
  - If you don't have the expertise, partner with someone who does
- Don't assume a court order gets you out of tax jail for free

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Tips & Strategies

- Consider informing opposing counsel of potential tax challenges of settling IRA beneficiary designation disputes
  - Tax savings can induce expeditious settlement
    - Make the IRS the bad guy so parties come together
  - Mediation can turn into a waste of time if parties don't understand applicable rules

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Tips & Strategies

- Consider using other assets to settle
  - Make "smart" choices where different assets present
  - Some people are better recipients of IRA assets
    - Charities (don't pay tax)
    - Low tax bracket TPs (OK to distribute within 5yrs anyway)
    - Surviving spouses (may be able to roll over)

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Questions?

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