labyrinth

A fascinating scenario crossed my desk the other day. With several layers of complexity, missed opportunities, blind alleys, and potential workarounds. The kind of thing I like to sink my teeth into. Such as they are. At two fifty an hour.

the scenario

Decedent dies after her required beginning date, *i.e.*, in what we call "pay status," with a substantial IRA. Either no beneficiary designation or literally designated to her estate. Or in another configuration, directly to her testamentary trust.

If to the estate, we would have no "designated" beneficiary, and the minimum required distributions would be calculated with reference to the decedent's "ghost" life expectancy. If directly to the trust, and if the trust qualified as lookthrough, and if the beneficiary were an "eligible" designated beneficiary, we could use her life expectancy. Which might not be longer anyway.

In either event, there is a residuary trust to which as a practical matter the entire IRA will be or has been distributed. That trust is to pay a fixed annuity to a nonspouse, let's say a sibling, for life, with the remainder to designated charities. But the amount of the annuity is nowhere near five pct., and the trust permits encroachments on principal for the income beneficiary, albeit under limited circumstances that are extremely unlikely to occur.

On its face this does not qualify as a charitable remainder annuity trust. And the deadline for initiating a proceeding to reform a nonqualified trust, which would be ninety days after the due date, with extensions, of the initial 1041 for the estate, has passed.

But even if it had not, it is not obvious how the trust could be reformed to qualify, while keeping the difference between values of the "reformable" and the "reformed" interests within five pct., which the statute does require.

But if we could.

alternate realities

In the particular case, the nonspouse beneficiary has a life expectancy well under twenty years, and we could set the annuity payout as high as eight or nine pct. before running up against the probability of exhaustion, which in any event we could address with a qualified contingency. Or we could set her up with a unitrust payout.

There might actually be some workable math here, involving renunciations or partial disclaimers -- for which latter, again, the deadline has passed --, maybe yielding a higher payout against a smaller principal balance, etc.

Something to keep in mind anyway, in case a similar situation arises in the future and you catch it early enough.

And one more thought.

If we were still within the deadline for a reformation but past the deadline for a qualified disclaimer, the beneficiary would be making a reportable gift to the remainder charities. Which you might think IRS would want to characterize as a nonqualifying partial interest, but maybe not, for reasons we will get into in a moment.

In any event, it would be difficult to assign a value to that interest, so the tax benefit would lie entirely with qualifying the trust as a section 664(d) trust.

what you have instead

But all of that is water under the bridge. We have to play the hand we are dealt. And other relevant cliches.

The residuary trust would likely have qualified as a lookthrough, had the beneficiary designation not been to the estate. You will see the occasional letter ruling allowing some post mortem maneuvering even here, if other probate assets are sufficient to cover creditor claims, etc., and if the executor has authority to make non- pro rata allocations. But typically these involve a spousal rollover.

And let's assume either pre-2020 rules or an "eligible" designated beneficiary, *i.e.*, a payout over the nonspouse benefiary's life expectancy. Nontax fiduciary income accounting principles would allocate distributions from the IRA ten pct. to income and ninety to principal. And because the trustee's discretion to encroach on principal is limited, it is likely

taxable amounts would have accumulated at the trust level, where they would have been taxed at higher marginal rates than if they could be distributed.

But the executor took a lump sum distribution, so we have a recognition event as to the entire amount.

The estate was not large enough to require filing a state or federal estate tax return. There either was or was not a fiscal year election for the 1041s for the estate, but the residuary trust, once it is up and running, will be on a calendar year.

the kicker

Seven hundred fifty words in, and we finally get to the heart of the matter. On a 1041 for the probate estate, the executor claimed a set-aside deduction for the present value of the remainder to charities. Yes, you read that correctly.

There are other reasons to amend that return, but the question on the table is whether a set aside deduction would be defensible.

Short answer probably not, but let's try to build the argument. Apparently the idea is that because there is almost zero likelihood the trustee will encroach on principal in the particular case, any amount of trust corpus beyond what would be required to generate the fixed annuity has been "set aside."

And let's just say, "beyond what would be required" to generate the annuity indefinitely, without taking into account the beneficiary's life expectancy. Leaving a smaller amount for the set aside, maybe a more defensible position.

This argument would have been strengthened had the beneficiary disclaimed or timely renounced her right to discretionary encroachments. A qualified disclaimer would have been effective retroactively to the decedent's death. But IRS would not be bound by the purported retroactive effect of a renunciation now, after the distribution to the residuary trust has already been made, and after the close of the tax year for which the executor has claimed a deduction.

If we had acted timely, the question would be whether the right to discretionary distributions is a "severable" interest, as to which the income beneficiary could have made a qualified disclaimer. Examples 9 and 11 at reg. section 25.2518-3(d) suggest the answer may be yes. Also two letter rulings,

PLRs 200010019 and 200230022. The same logic ought to apply to a renunciation, outside the nine month limit for a disclaimer but timely to support the executor's reporting position.

If the estate were on a noncalendar fiscal year, and if the calendar reporting year for the residuary trust into which the distribution was received were still open, it might still be possible to paper this over.

And what might that look like? A renunciation of the right to discretionary encroachments, followed by a decanting of the set aside amount into a section 4947(a)(1) nonexempt trust. That distribution, albeit not to an exempt entity, would arguably be "for a purpose specified in section 170(c)," and thus deductible under section 642(c)(1). IRS has ruled favorably on this latter point at least twice, in PLRs 200009058 and 200235035.

And since we are now talking about a distribution rather than a set aside, we should be able to make an election under reg. section 1.642(c)-1(b) to treat a distribution made in year two as having been made in year one. If the year two return is still open and maybe on extension.

Ariadne's thread

Or let's suppose it is too late to rescue the deduction at the estate level. The return claiming a charitable set aside is amended to show instead a distributions deduction to the residuary trust, but the trust has closed its initial calendar year without having dealt with the problem.

But if we are still in year two, might it not yet be possible for the beneficiary to renounce, and for the trustee to then decant into a section 4947(a)(1) nonexempt trust, and still make the election to claim the deduction for the prior year?

By sifting through multiple strategies that for one reason or another cannot salvage the situation, we seem to have hit upon one that might.

Of course, the trust beneficiary would have to get comfortable with renouncing her right to discretionary encroachments on principal, and the advisors who are subject to Circular 230 would have to get comfortable with the idea that this is a reasonable reporting position.

about the author

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About three years ago, he launched a newsletter, the Jack Straw Fortnightly, analyzing current developments in the law -- both tax and nontax -- concerning the transfer of private wealth in this country. Russ also writes for publication in various tax journals and other outlets, and has spoken at any number of national and regional conferences, and to local planned giving roundtables, community foundations, and bar associations.

Russ has a law degree from St. Louis University and a master's degree in taxation law from Washington University in St. Louis. His undergraduate degree in English literature is from Indiana University, Bloomington, and he has a master's degree in English from the University of Chicago.

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