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The IRS Issues Final Rules for Minimum Required Distributions

At long last, the IRS has issued final rules for minimum required distributions from qualified plans, IRAs, 403(b) annuities, and 457 plans. 67 Fed Reg 18,988 (Apr. 17, 2002). The final rules supplant proposed regulations issued in 1987 and amended in 1997 and 2001. *See* 52 Fed Reg 28,070 (July 27, 1987); 62 Fed Reg 67,780 (Dec. 30, 1997); 66 Fed Reg 3928 (Jan. 17, 2001) (corrected in From Retirement Plan, 2001-11 IRB 865). This article summarizes the highlights of the final rules.[1] Except where noted otherwise, citations in this article to regulations refer to the final rules.

The final rules take effect in 2003. For 2002 distributions, IRA owners may comply with either the 1987 proposed rules, the 2001 proposed rules, or the 2002 final rules. 67 Fed Reg at 18,994. However, nearly all taxpayers will prefer the 2002 rules. The final rules give certain beneficiaries until the end of 2003 to switch from the five-year rule for withdrawals to withdrawals based on their life expectancies. Treas Reg § 1.401(a)(9)-1, A-2(b)(2). This transition rule will particularly help beneficiaries designated by the owner after the owner's required beginning date ("RBD").

Review of the Basic Rules of Beneficiary Designations

RBD and Minimum Required Distributions. For most retirement-plan participants (including owners of IRAs), the RBD is April 1 of the year after the calendar year in which the participant turns 70 1/2. Under the pre-2001 regulations, the RBD was a critical deadline for participants to (1) start taking minimum required distributions ("MRDs"), (2) designate a beneficiary or irrevocably be treated as having no designated beneficiary, and (3) elect whether to recalculate their life expectancies for measuring required distributions. Recalculation could have a major impact on tax deferral and the risk of outliving one's retirement benefits.

Under the 2001 proposed rules and the final rules, the RBD shrinks in importance. Designated beneficiaries are now determined as of the date of death (or in some cases even as late as September 30 of the calendar year following the date of death). Thus an owner may now name or change designated beneficiaries after the RBD without ill effect. Moreover, as the following paragraphs explain, the rules for MRDs were liberalized.

Payees of retirement plans, including most IRAs, must withdraw a varying percentage of the account balance each year, starting at the RBD. Each year's mandatory withdrawal is known as the MRD. The account payee is free to withdraw faster than the MRD rate. If the actual withdrawal during the year is less than the MRD, the payee owes a 50 percent excise tax on the shortfall. IRC

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§ 4974(a). Roth IRAs are a major exception, since no distributions are required during the life of the original owner.

For distributions during the owner's lifetime, the key feature of the 2001 proposed regulations was a new uniform table for calculating required distributions. The final regulations call that table the Uniform Lifetime Table. Treas Reg § 1.401(a)(9)-9, A-2. As before, MRDs must begin by the RBD. In essence, the MRD for each year equals (1) the account balance at the end of the prior year divided by (2) the "applicable divisor" from the uniform distribution table that corresponds to the owner's age reached during the year of distribution.

For most owners, MRDs using the Uniform Lifetime Table no longer depend on the age of the owner's designated beneficiary. Also, an owner no longer must decide whether to "recalculate" his or her life expectancy or a spouse's life expectancy. The decision of whether to "recalculate" presented owners with a dilemma. Recalculation—as opposed to using fixed-term life expectancies—meant smaller required payments during the life of the owner and spouse whose life expectancies were being recalculated. However, the bill for recalculation came due at the owner's death. The owner's (or spouse's) life expectancy became zero, MRDs accelerated, and in some cases the entire balance had to be withdrawn in the year after death.

The new rules offer the best of both recalculation and the fixed-term method. The Uniform Lifetime Table assumes recalculation during the owner's lifetime; assumes that the owner is married, with a spouse 10 years younger; and applies their joint and last survivor life expectancy on a recalculated basis. *See* 67 Fed Reg at 18,989. (The resulting figures in the 2001 proposed rules were equivalent to the former Minimum Distribution Incidental Benefit table appearing in Appendix E of pre-2001 versions of IRS Publication 590. Life expectancies stretch out even more in the 2002 Uniform Lifetime Table, reflecting more recent mortality data.) At the owner's death the new rules automatically convert to the fixed-term method, avoiding the brutal acceleration after death for required withdrawals with recalculation.

A simple example illustrates the benefit of the new Uniform Lifetime Table. Consider a married owner, age 73, with a 70-year-old spouse as the designated beneficiary. The new Uniform Lifetime Table requires the owner to withdraw 4.0 percent of the previous year-end balance. Under the prior rules, the owner would have had to withdraw between 5.1 and 7.2 percent of that balance, depending upon when the spouse's birthday fell during the calendar year, whether the owner named the spouse as the designated beneficiary by the RBD, and whether the spouse recalculated his or her life expectancy.

A small minority of owners—namely, those with a spouse as sole beneficiary who is more than 10 years younger—should not use the Uniform Lifetime Table. Instead, they should calculate MRDs using their actual joint and last survivor life expectancies as shown on the Joint and Last Survivor Table. Treas Reg § 1.401(a)(9)-9, A-3.

Advantage of Having a Designated Beneficiary. For many clients, there is a significant advantage in having a designated beneficiary. Most retirees hold a mixture of (1) retirement plan benefits, with earnings that are *tax-deferred* until withdrawn, and (2) other assets, such as stocks, bonds, bank accounts, mutual funds, and real estate, with earnings that are *currently taxed*. Normally, the best approach is to dip into currently taxed savings for living expenses, while preserving retirement benefits for continued, tax-deferred compounding as long as possible. This is true whether the participant dies before or after the RBD.

Distributions After Owner's Death. As before, MRDs after the owner's death depend on whether there is an individual designated beneficiary. If there is such a beneficiary, MRDs for years after the owner's death are normally based on the beneficiary's single life expectancy, whether or not the owner died before or after the RBD. The MRD for the year of the owner's death uses the owner's life expectancy from the Uniform Lifetime Table, based on his or her age attained that year. Treas Reg § 1.401(a)(9)-5, A-4(a).

Surviving Spouse as Designated Beneficiary. Surviving spouses are favored in three respects. While they are alive, their MRD calculations preserve the benefit of recalculation. If an owner dies before his or her RBD, the spouse—unlike a nonspouse designated beneficiary—may elect to delay distributions until the year the owner would have become 70 1/2. Treas Reg § 1.401(a)(9)-3, A-3(b). Finally, as under the old rules, a surviving spouse may elect to convert or roll over the account to his or her own IRA and designate new beneficiaries. Treas Reg § 1.408(8), A-5. Required distributions will then be based on the Uniform Lifetime Table, which permits slower withdrawals than the Single Life Table.

To convert an IRA to the surviving spouse's own IRA, the surviving spouse must be the sole beneficiary and must have an unlimited right to withdraw amounts from the IRA. In the view of the IRS, this requirement disqualifies a trust named as IRA beneficiary, even if the surviving spouse is the sole beneficiary of the trust. Treas Reg § 1.408-8, A-5(a). Also, the surviving spouse cannot make the election until the MRD is taken for the year of the owner's death. *Id*.

Questions, Comments or Suggestions About This Newsletter?

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One trap arises if the surviving spouse dies soon after the owner. If the owner died before his or her RBD, and the surviving spouse, who is the sole designated beneficiary, then dies before September 30 of the year after the year of the participant's death), then required distributions after the surviving spouse's death will not be based on her remaining life expectancy. Instead, a new distribution period starts, and benefits must be distributed either by the end of the year including the fifth anniversary of the surviving spouse's death or, if he or she named a designated beneficiary before his or her death, in annual installments over that beneficiary's life expectancy. Treas Reg §§ 1.401(a)(9)-3, A-5 & A-6, 1.401(a)(9)-4, A-4(b).

*Other Individual Designated Beneficiary***.** If there is a designated beneficiary other than the participant's spouse, then the distribution period for the year after the year of the owner's death is normally the divisor on the Single Life Table corresponding to the beneficiary's attained age in that year after death. Treas Reg § 1.401(a)(9)-5, A-5(c)(1); *see* Treas Reg § 1.401(a)(9)-9, A-1. For each succeeding year, the initial divisor is reduced by one. Thus nonspouse beneficiaries cannot recalculate their life expectancies.

A helpful exception to the preceding paragraph provides that if the participant dies on or after the RBD, the measuring period is the greater of (1) the period above or (2) the participant's remaining life expectancy, reduced by one each following year, from the Single Life Table. Treas Reg § 1.401(a)(9)-5, A-5(a)(1). This exception makes it easier for a participant to name an older designated beneficiary.

If there are multiple nonspouse beneficiaries, the shortest life expectancy controls. Treas Reg § 1.401(a)(9)-5, A-7(a)(1). If the spouse and others are designated beneficiaries, the nonspouse rules apply. But, as is explained below, it may be possible to sever the interests of beneficiaries so that the interests of younger beneficiaries are not tainted by the life expectancies of older beneficiaries.

No Individual as Designated Beneficiary. The new rules continue the principle that a nonindividual beneficiary cannot qualify as a designated beneficiary. Treas Reg § 1.401(a)(9)-4, A-3. If any nonindividual is named as a beneficiary, the account is treated as having no designated beneficiary, even if there are also individual beneficiaries. *Id*.

What is the effect of having no designated beneficiary? If the participant dies before the RBD, then the entire retirement-plan balance must be withdrawn—and exposed to income tax—within five years after the date of death. Treas Reg § 1.401(a)(9)-3, A-4(a)(3). On the other hand, if the participant dies on or after the RBD, then the beneficiaries must take distributions based on the participant's life expectancy without recalculation, from the Single Life Table. In other words, each year, the participant's life expectancy is reduced by one. Treas Reg § 1.401(a)(9)-5, A-5(c)(3).

One saving grace, with no designated beneficiary, is that no distribution is required until the end of the five years. A beneficiary can wait to withdraw the entire balance at the end of the five years, without incurring the 50 percent penalty under IRC § 4974. Treas Reg § 54.4974-2, A-3(c).

Estates. The IRS has reaffirmed its prior view that estates do not qualify as designated beneficiaries. Treas Reg § 1.401(a)(9)-4, A-3.

Trusts as Designated Beneficiaries

Trusts, unlike estates, may qualify as designated beneficiaries, if they meet the requirements described below. If the trust so qualifies, required distributions are based on the life expectancy of the oldest trust beneficiary. Treas Reg §§ 1.401(a)(9)-4, A-5(c), 1.401(a)(9)-5, A-7. Thus the estate plan can preserve assets in trust while stretching out required distributions to defer income taxes.

The Basic Four Requirements for Trusts as Designated Beneficiaries. A trust qualifies as a designated beneficiary if, as of the later of the date the trust is named as beneficiary or the RBD, and at all later times while the trust is a plan beneficiary, the following requirements of Treas Reg § 1.401(a)(9)-4, A-5 & A-6 are satisfied: (1) the trust is valid under state law, or would be but for the fact that there is no corpus; (2) the trust is irrevocable or will become irrevocable, by its terms, upon the participant's death; (3) trust beneficiaries are "identifiable" from the trust instrument; and (4) suitable documentation has been timely furnished to the plan administrator. The life expectancy of the oldest beneficiary is then used to determine MRDs.

"Identifiable" Trust Beneficiaries. Unfortunately, the final rules do not fully clarify when trust beneficiaries are "identifiable." Three potential traps involve contingent remainder beneficiaries, estate expenses, and spray powers or powers of appointment.

It is hard to tell which contingent remainder beneficiaries count. The stakes are high, since the presence of an ineligible remainder beneficiary, such as a charity or a decedent's estate, taints the entire trust, so that the employee is deemed to have no designated beneficiary. The final rule apparently permits one to ignore beneficiaries who take only if the preceding beneficiaries die prematurely, before reaching their life expectancies. *See* Treas Reg § 1.401(a)(9)-5, A-7(b) & A-7(c)(1). One safe harbor is simply to omit the charity as trust beneficiary and to leave other assets to the charity. Also, the IRS will ignore contingent remainder beneficiaries named in a "conduit" trust that requires the trustee to pay (rather than retain within the trust) each year's MRDs to one or more named individuals during the life expectancy of the oldest. Treas Reg § 1.401(a)(9)-5, A-7(c)(3), 2. Furthermore, it appears that the IRS will permit beneficiaries to have a special power of appointment as to remaining retirement funds as long as the power prohibits appointment to (1) an individual older than the oldest designated beneficiary, (2) any person other than a trust or an individual, or (3) any trust that may have a beneficiary excluded by (1) or (2). *See, e.g.*, Priv Ltr Rul 200235038 (Aug. 30, 2002).

The trust document should prohibit retirement-plan assets from being used to pay estate taxes, debts, and expenses.

Otherwise, the IRS may argue that the estate, a nonindividual, is a beneficiary. If there are not enough other assets to pay taxes and expenses, an alternative is to earmark a separate account in a retirement plan (or a separate IRA) for that purpose.

Do Trusts as Designated Beneficiaries Make Sense? Naming trusts as beneficiaries in this manner is not a panacea. These trusts create complexity for family members and technical traps for lawyers. If the trust is a QTIP trust, and the surviving spouse lives to his or her life expectancy (or close to it) the goal of leaving part of the retirement plan for children of a prior marriage may be thwarted. *See* Jonathan A. Levy, "An Update on Making Retirement Benefits Payable to Trusts," 14 *Prob & Prop* 24, 27 (Nov./Dec. 2000). Retirement-plan trusts make the most sense when a client's family includes minors, spendthrifts, or children in unstable marriages or if a retirement plan is the only asset available to fund a credit shelter trust. However, for many married clients, the better tack is simply for each spouse to name the other as beneficiary. If the non-participant spouse is the survivor, then he or she can roll over the account to a new IRA and name new designated beneficiaries (usually children or grandchildren), with years or decades more of income tax deferral. In contrast, as noted above, the surviving spouse who receives retirement funds as a trust beneficiary cannot elect a rollover.

Remedial Strategies from the Final Rule

A key feature of the final rule is that designated beneficiaries are determined as of September 30 of the year after the year of the owner's death. Treas Reg § 1.401(a)(9)-4, A-4(a). Any beneficiary that is eliminated between the date of death and the September 30 deadline is disregarded in determining designated beneficiaries. This suggests three possible strategies to slow the pace of required withdrawals when there are "disfavored" trust beneficiaries—that is, elderly individuals or nonindividuals.

First, disfavored beneficiaries may disclaim their interests in an account before the September 30 deadline. *Id*. Normally, this will appeal only to wealthy older relatives of contingent trust beneficiaries who will take as a result of the disclaimers. Make sure that the disclaimers qualify under state disclaimer law and IRC § 2518 to avoid adverse gift tax consequences. Also, review state law and the relevant documents to confirm that the disclaimed funds will not end up in unexpected hands.

A second technique is to distribute the shares of disfavored beneficiaries before the September 30 deadline. As with disclaimers, the cashed-out beneficiaries ought to be disregarded in calculating MRDs. This technique may prove useful with charitable beneficiaries, which will not bear income tax on distributions, accelerated or not, and which will be pleased to be paid early.

A third technique is to split the retirement account into separate shares (or separate accounts, for defined-benefit plans) by September 30 of the year after the year of death. 67 Fed Reg at 18,992; Treas Reg § 1.401(a)(9)-8, A-2 & A-3. (Although the final rule appears to permit a division into separate shares as late as December 31 of the year after the date of death, designated beneficiaries are generally determined as of September 30 of the year after the date of death, and for that reason it is safer to apply the September 30 deadline.) A separate account is a portion of the owner's plan benefit determined by acceptable separate accounting, including allocating investment gains and losses, contributions, and forfeitures, on a pro rata basis. Treas Reg § 1.401(a)(9)-8, A-3. The MRDs of each share are calculated separately. *Id*. Thus the shorter (or zero) life expectancies of older beneficiaries or charities ought not to accelerate distributions for younger beneficiaries. As a practical matter, however, it is often better for owners with diverse beneficiaries to transfer retirement benefits to separate IRAs during their lifetimes. Some plan sponsors are not set up to handle separate-share accounting.

Conclusion

The final regulations simplify planning for required distributions from retirement assets. However, pitfalls remain. Estate planners should carefully review the details of the final regulations, IRS letter rulings and other published interpretations, and the particular terms of clients' retirement-plan documents.

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1 Some of this material is drawn from two of the author's previous articles: "An Update on Making Retirement Benefits Payable to Trusts," 14 *Prob & Prop* 24 (Nov./Dec. 2000), and "The IRS's New Proposed Rules for Required Minimum Distributions," 15 *Prob & Prop* 16 (2001).

Common Questions and Little Known Facts Relating to Advance Directives

Oregon practitioners have been using the statutorily required Advance Directive form since late 1993 when the legislature enacted the Oregon Health Care Decisions Act (the "Act"). While the new form is an improvement over prior health care forms, the Advance Directive still causes some confusion for both attorneys and clients. This article addresses common questions asked by clients and some lesser-known facts relating to Advance Directives.

When can the Advance Directive be used by my health care representative? The Advance Directive form may be used by the health care representative only when the principal is incapable. ORS 127.535(1). A principal is incapable when he or she lacks the ability to make and communicate health care decisions to health care providers. ORS 127.505(13).

If the principal is incapable, the health care representative has all authority over the principal's health care that the principal would have if not incapable. See ORS 127.505(13). In the Advance Directive form, however, the person appointing a health care representative must initial Items 2 and 3 of Part B if he or she wants the health care representative to make decisions about life support and/or tube feeding. If Items 2 and 3 are not initialed, the health care representative may not make decisions involving life support and tube feeding. If the principal also completes the Health Care Instructions on Part C, the representative has a duty to act consistently with the desires expressed in the instructions. ORS 127.535(4).

Can I appoint my doctor to act as my health care representative? A principal cannot appoint his or her doctor as the health care representative unless the doctor is related to the principal by blood, marriage, or adoption. In addition, the following persons cannot serve as a health care representative:

- Any employee of the attending physician and
- An owner, operator, or employee of a health care facility where the principal is a patient or resident unless the representative was appointed before the principal's admission to the facility. ORS 127.520(1).

A capable adult may disqualify any other person from serving as representative by listing the name or names in the Advance Directive. ORS 127.520(2). Any person whose authority has been revoked by a court is also disqualified. ORS 127.520(2).

What if my parent is not competent to sign an Advance Directive; am I allowed to make health care decisions for him or her? The Act provides a list of persons to make health care decisions if a health care representative has not been appointed and a person's condition meets one of the four conditions listed in the Act. The four conditions listed in the Act are the same conditions listed in Part C of the Advance Directive. The person designated to make health care decisions relating to life support on behalf of another without an Advance Directive will be the first person located and willing to serve from the following list in this order of priority:

- A guardian appointed to make health care decisions.
- The principal's spouse.
- An adult willing to serve and designated by the others on this list that can be located. The adult may serve if no person on this list objects to the designation.
- A majority of the adult children who can be located.
- Either parent of the principal.
- A majority of the principal's adult siblings who can be located.
- Any adult relative or friend. ORS 127.635(2).

If no one from the above list is available, life support may be withdrawn at the direction of the attending physician. ORS 127.635(3).

Note that this provision gives the authorized person the right to make health care decisions only if the person is in one of the four listed conditions in Part C of the Advance Directive. This provision does not authorize the person to make medical decisions outside of the four specified conditions.

If I initial Items 2 and 3 in Part B giving my health care representative the authority to make decisions about life support and tube feeding, what happens if the health care representative refuses to follow my Health Care Instructions in Part C? By initialing Items 2 and 3 in Part B and signing the Health Care Instructions in Part C, the principal is in effect giving the health care representative the authority to implement the principal's decisions, not to make different decisions. As a result, the health care representative cannot depart from the choices made by the principal in the Advance Directive. ORS 127.535(4). If the health care representative does not agree with the choices made in the Health Care Instructions, he or she may resign.

In addition, doctors are not at liberty to depart from instructions made by a principal or by a validly appointed health care representative. ORS 127.625(2). If the doctor believes a health care representative is violating the choices made in the Advance Directive, the doctor must promptly notify the representative of the discrepancy. ORS 127.625(2)(a). If the representative refuses to follow the Advance Directive, the representative or the doctor may ask a court to resolve the dispute. ORS 127.625(2)(b) and

127.550(2). Unless notified of a conflict, the Act does not make the doctor responsible for determining whether the representative followed the principal's instructions found in the Advance Directive.

In Part B, Item 1, the form allows me to initial the statement "I have executed a Health Care Instruction or Directive to Physicians," but the Health Care Instructions come after this item in Part C. If I have not completed Part C yet, what effect does initialing Part B, Item 1 have? The legislative intent indicates this statement refers to previous documents signed by the principal rather than the current Advance Directive. Ted Falk, "Questions and Answers About Advance Directives," *Est Plan & Admin Sec Newsl*, at 3 (Oct. 1994). However, this explanation still causes confusion, since Item 7 in Part C specifically deals with any previous "health care power of attorney" signed by the principal. If the statement in Part B refers to the current Health Care Instructions, it should be located in Part C because the principal signs the Health Care Instructions in Part C. Under either interpretation (current or previous Health Care Instructions), the most recent Health Care Instructions signed by the principal will be the effective document unless the Health Care Instructions provide otherwise. ORS 127.545(4). If the principal completes Part C on the current Advance Directive, the Part C Health Care Instructions will supersede any previous health care document. If the principal does not complete Part C on the current Advance Directive, any previous Health Care Instructions or Directive to Physicians would remain in effect unless revoked in Item 7 of Part C.

What does item 7 in Part C mean; it sounds like I am given the option of revoking the instructions I just signed? Item 7 applies to any prior health care documents signed by the principal that appoint a representative to make health care decisions. It does not apply to the current instructions given in Part C of the Advance Directive.

Do my witnesses have to sign the Advance Directive at the same time I do? No, the two witnesses must either witness the actual signing of the Advance Directive by the principal or witness the acknowledgement of the signatures by the principal. ORS 127.515(4). In addition, at the time of signing, one of the witnesses must not be a relative of the principal, must not be entitled to any part of the principal's estate, and must not be an owner, operator, or employee of a health care facility where the principal is a resident or a patient. *Id*. Neither the health care representative nor the treating doctor can serve as a witness. However, if the principal is a resident of a long-term care facility, one of the witnesses *must* be a person designated by the facility. ORS 127.515(4)(e). This requirement is not stated in the statutory form for the Advance Directive and is frequently missed by clients and practitioners.

To whom should I give copies of the signed Advance Directive? The principal should give a copy of the signed Advance Directive to his or her treating physicians; the long-term care facility if the client is residing in one; the health care representatives; other close family, friends, and/or neighbors; and his or her attorney. If a health care provider is given a copy of an Advance Directive, the provider must make it a part of the principal's medical record. ORS 127.510(5).

Am I allowed to change the wording in the Advance Directive? Oregon residents must use the statutory Advance Directive form. However, the principal may cross out words and add words to better express his or her wishes. ORS 127.531(1).

Are there any medical decisions that my health care representative cannot make on my behalf? Yes. The Act specifically prohibits a health care representative from making the following health care decisions on behalf of the principal:

- Admission to or retention in a health care facility for care or treatment of mental illness.
- Convulsive treatment.
- Psychosurgery.
- Sterilization.
- Abortion. ORS 127.540.

A principal may sign a Mental Health Directive to give someone the authority to make mental-health-related decisions on his or her behalf. A statutory form, often overlooked by clients and practitioners, is located at ORS 127.736.

If I want to revoke the Advance Directive, how do I do it? Written revocation is always best. However, the Act states that the decision to withhold or withdraw life-sustaining procedures or artificially administered nutrition and hydration may be revoked at any time and in any manner by which the principal is able to communicate the intent to revoke or may be revoked at any time and in any manner by a capable principal. ORS 127.545(1). The revocation is effective upon communication by the principal to the attending physician or health care provider or to the health care representative. ORS 127.545(2).

What if I have signed an Advance Directive and I later have a guardian appointed for me; does the guardian or the health care representative make medical decisions on my behalf? The appointment of a valid health care representative supersedes any power of a guardian or other person appointed by court to make health care decisions for the protected person. ORS 127.545(6). However, a judicial review may determine if the health care representative should be removed and the guardian placed in charge of making medical decisions. ORS 127.550; *see also* ORS 125.315(1)(c).

I recently divorced my spouse, do I need to redo my Advance Directive? The appointment of the spouse as the health care representative is suspended if a dissolution or an annulment of marriage is filed and the principal does not reaffirm the appointment in writing after the filing of the petition. ORS 127.550; see also ORS 125.315(1)(c). Note that a final decree is not necessary to suspend the spouse's authority as a health care representative. The filing of the petition automatically suspends a spouse's authority as the health care representative.

I have heard that paramedics coming to my house in an emergency will not honor my Advance Directive; is that correct? Emergency technicians and paramedics are required to provide emergency treatment to a patient unable to convey his or her desires, including life-sustaining procedures, unless there is a doctor's order to the contrary. The Advance Directive is not a doctor's order and is not controlling in an emergency situation in which paramedics are providing treatment. If the principal is seriously ill, the principal should request that his or her treating physician sign a Physician's Order for Life Sustaining Treatment (the "POLST"). The POLST is frequently called the pink sheet because of its hot pink color. The POLST serves as a physician's order to withhold treatment and can be given to paramedics.

Conclusion

Despite certain confusing aspects, the importance of the Advance Directive should not be underestimated as part of an estate plan. As the above paragraphs illustrate, practitioners need an accurate understanding of the Act and the Advance Directive form to properly effectuate their client's health care decisions.

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Primer On The New Regime For Taxation of Split-Dollar: Notice 2001-10 And Its Successor Notice 2002-8

Note: This Article is being presented in two parts. In Part One, published in July, the author (a) provided the background for Notice 2002-8, including Notice 2001-10, (b) discussed the anticipated content of the Proposed Treasury Regulations regarding split-dollar agreements, (c) reviewed the impact of republishing Table 2001, and (d) discussed the impact of Notice 2002-8 on other types of split-dollar financing.

In Part Two, the author (a) discusses the regime that will apply to split-dollar agreements that will be entered into before the adoption of Final Treasury Regulations, (b) speculates regarding future developments in the area of split-dollar agreements, and (c) offers strategies for working with the new rules of Notice 2002-8.

The Service issued Proposed Regulations on July 9, 2002. The author will address the proposed regulations in an additional article to be published in the January issue of the Newsletter. The author will (a) discuss the impact of the proposed regulations, (b) explain how the regulations interface with Notice 2002-8, and (c) address the impact of Notice 2002-59, which deals primarily with perceived abuses of reverse split-dollar financed life insurance.

Split-Dollar Insurance Arrangements Before Publication of Final Treasury Regulations

Because the Proposed Treasury Regulations will apply to split-dollar agreements entered into before the publication of Final Treasury Regulations, the Service provided four paragraphs of interim guidance in Notice 2002-8 for existing split-dollar agreements and those entered into before publication of the Final Treasury Regulations. Three of the paragraphs pertain to agreements that have been entered into before the publication of Final Treasury Regulation and the fourth paragraph pertains to agreements entered into before January 28, 2002.

First, the Service will not impose income tax on the annual incremental cash build-up of equity that is owned by the employee. This statement rebuts the notion advanced by the Service in Tech Adv Mem 9604001 (Sept. 8, 1995), which was not explicitly refuted in Notice 2001-10.

Second, in a situation involving a collateral-split dollar agreement, the Service will not find the agreement terminated, and thus attempt to assert an income tax on the accrued equity build-up at that time, if the parties continue to report the economic benefit attributable to the insurance coverage. This treatment should be afforded in the context of a crawl-out from the arrangement. Under this technique, the employer's interest in the cash value is typically repaid from the cash value of the policy over several years. The crawl-out technique was a concern to the Service when it issued Notice 2001-10, and it has suggested that there might be a termination when the employer's interest in the cash value became de minimis. The Service is saying in the current Notice that as long as the collateral split-dollar agreement is in place and the employer has <u>some</u> remaining interest in the cash value, the agreement will not be deemed terminated.

Third, as in Notice 2001-10, the parties are free to characterize a split-dollar arrangement (for either endorsement or collateral split-dollar) as an interest-free loan and have the agreement taxed under §§ 1271-1275 dealing with original issue discount and § 7872 dealing with interest-free loans. This election is available for all agreements entered into before the Final Treasury Regulations. Section 7872 was not enacted at the time that the Service initially sought to tax benefits afforded in split-dollar arrangements as interest-free loans in Rev Rul 55-747, 1955-2 CB 228. The Tax Court stated in *Dean v. Comm'r*, 35 TC 1083 (1961), that an interest-free loan had no tax consequences to an employee-debtor. In response, the Service announced the economic benefit method of taxation of split-dollar in Rev Rul 64-328, 1964-2 CB 11, using the annual term cost of insurance coverage provided to the employee by the employer's payment of premium as the measurable annual benefit.

The Service acknowledged that the Treasury Regulations under § 7872 do not specifically provide how interest-free loans in the split-dollar situation might be taxed, and accordingly, the Service will reward good-faith efforts made by the taxpayer to comply, pending additional clarification. For instance, how does one distinguish various types of loans that might be employed, such as demand, hybrid, or term loans? Does each premium payment constitute a separate loan that would be subject to separate interest rates? This would be administratively challenging if monthly premiums were involved. The Service has suggested informally that it will work to have some kind of consolidated loan method employed in which multiple premium payments are made throughout the year.

Presently, the three types of below-market loans are defined in the Code and Treasury Regulations as follows:

- Demand Loan. Section 7872(f)(5) defines a demand loan as any loan with an indefinite maturity or that is payable on the demand of the lender. Under a demand loan the employer is deemed to pay as compensation to the employee the amount of forgone interest, and the employee is deemed to repay that amount simultaneously to the employer as interest paid on the loan. These transfers are deemed to occur on the last day of the calendar year to which they are attributable. IRC § 7872(a)(2). The interest rate charged on the loan will be the "blended annual rate" published annually by the Service, which is the average of the applicable federal rates ("AFR") for demand loans outstanding for the entire year. Prop Treas Reg § 1.7872-13(a)(1).
- Term Loan. Section 7872(f)(6) and Prop Treas Reg § 1.7872-10(a)(2) define a term loan as one for which the agreement specifies an ascertainable period of time (which includes a period determined actuarially) during which the loan is to be outstanding or, by default, any loan that is not a demand loan. The interest rate charged on a term loan will be the appropriate short-, mid-, or long-term AFR in effect on the date the loan is made. On that date, the employee will be considered to have received an amount of compensation equal to the amount of the loan minus the present value of all future payments required to be made under the terms of the loan. IRC § 7872(b)(1). The amount of imputed income recognized by an employee on the issuance of an interest-free term loan could be quite large if repayment is not required for a number of years.
- Hybrid Loan. Section 7872(f)(5) defines a hybrid loan as a term loan that will be treated as a demand loan if the loan (1) is nontransferable and (2) is conditioned on the future performance of substantial services by the employee, as such terms are treated within the meaning of § 83. Prop Treas Reg § 1.7872-10(a)(5). In the case of a hybrid loan, the timing of the imputed income payments will be identical to those made for a demand loan, but the interest rate will be the appropriate AFR for a loan of the term specified in the loan agreement.

Fourth, for existing split-dollar collateral assignment agreements and those entered into before January 28, 2002, the Service will not levy an income tax on incremental build-up inuring to the benefit of the insured employee if (a) the arrangement is terminated and rolled out before January 1, 2004 or (b) the arrangement is continued after January 1, 2004 and all payments by the sponsor from the inception of the arrangement (less any repayment to the sponsor) are treated as loans for federal tax purposes and the parties report the tax treatment in a consistent manner. This paragraph addresses the grandfathering issue by giving incentives to terminate the agreement or to switch to interest-free loan reporting in 2004.

The certainty of interest-free loan treatment comes with a price: the loan amount on which the forgone interest will be computed after January 1, 2004 will consist not only of the payments made in 2004 and beyond, but all prior payments that are to be repaid to the sponsor since the arrangement began. This seems harsh since we assume that the parties have consistently reported the prescribed economic benefit for all those years and now the prospective economic benefit in the form of forgone interest will be computed not only on the new debt created after 2003, but on all prior payments as well. On the other hand, the employee would be in roughly the same economic situation that he or she would be in if the employee had borrowed as a policy loan the amount necessary to pay off the employer and would be responsible for interest payments to the insurer.

One expects comprehensive treatment by the Final Treasury Regulations of all split-dollar-type relations. Were an employer and an employee to charge the AFR for premiums advanced by the employer instead of relying on interest-free loan treatment, the forthcoming Treasury Regulations should address that issue and give similar treatment as afforded interest-free loans. If the employer is to recoup the lesser of the premiums advanced or the cash surrender value at the termination of the agreement, one would expect consistency of treatment with the interest-free loan suggested in Notice 2002-8. There should be no income recognized if there is a discrepancy between the cash surrender value and the premiums paid, because the loan is treated as a nonrecourse debt with the employee that is secured only by the cash surrender value. This is the flip side of the problem specifically addressed in Notice 2002-8 in which the cash value exceeds the premiums advanced by the employer. In that situation no gain would be recognized by the employee on the difference between the value of the advanced premiums and the cash value on termination of the agreement so long as the obligation to repay the employer remains and there has been consistent treatment recognizing the amount of the forgone interest by the employee during the contractual relationship.

The interest-free loan techniques are discussed in the context of the collateral split-dollar agreement. It would be difficult to apply these techniques in the endorsement split-dollar setting. When the employer owns the policy and pays the premium, how would one fund debt owed by the employer to itself? However, the forgone interest on such a hypothetical debt could be used as the measurement of the tax benefit on an annual basis. It would provide a consistent measurement regardless of the type of split-dollar contract employed.

On termination of the endorsement arrangement and transfer of the policy to the employee, § 83 would compel recognition of gain to the extent of the cash value of the policy. Alternatively, § 108 should produce the same amount of gain to be recognized by the employee on cancellation of the obligation to repay the employer. Section 108 cancellation of indebtedness income would also be recognized if the employer cancelled the obligation to repay premiums advanced in the collateral split-dollar arrangement.

What Happens Next?

The Service asked for written comments by April 28, 2002 before issuing Treasury Regulations. Presumably, the issuance of Proposed Treasury Regulations would be followed by an opportunity for public comment. (As of publication, the Proposed Treasury Regulations have yet to be issued.)

Notice 2002-8 also contains language stating that "no inference should be drawn from this notice regarding the appropriate Federal income, employment and gift tax treatment of split-dollar life insurance arrangements entered into before the date of publication of Final Treasury Regulations." One could infer that equity build-up under agreements entered into after

April 28, 2002 would be taxed on rollout whenever it occurred. The best explanation of this statement is that the Service has conceded nothing with respect to potential arguments on the taxation of incremental build-up of policies issued after January 28, 2002 if the parties do not elect interest-free loan reporting of the economic benefit.

One hopes that in the collateral split-dollar context those contracts effective before the Proposed Treasury Regulations, or ideally Final Treasury Regulations, would not be subjected to the in terrorem treatment of possible taxation on rollout. It should also clarify the existing taxation of split-dollar agreements were the Service to adopt, prospectively on issuance of Final Treasury Regulations, interest-free loan treatment as the exclusive method of taxation, for collateral split-dollar arrangements and perhaps endorsement arrangements as well. The application of interest-free loan treatment to endorsement split-dollar arrangements is of less concern to the Service. Section 83 and § 61 would apply to impose a tax on the rollout of any equity portion in an endorsement arrangement since the employer is transferring property (i.e., the equity) to the employee.

Strategies Under Notice 2002-8

- Consider using the endorsement method for new policies to report the arrangement on an economic benefit basis. Conversion of a collateral split-dollar arrangement to an endorsement arrangement would not seem wise, because it would be deemed a sale of the original policy by the insured and would result in recognition of gain.
- Crawl out of existing policies and take your chances on having the event ultimately determined to be a taxable transfer of equity under the collateral split-dollar method. Notice 2002-5 does not address the consequences of continuing the crawl-out beyond January 1, 2004.
- Review all existing split-dollar arrangements. The parties need to assess the impact of a rollout or conversion to interest-free loan reporting under Notice 2002-8's safe harbor for existing collateral split-dollar agreements. The parties need to evaluate the extent now and in the future of the tax cost if there is a taxable rollout. The Service still has an uphill battle in justifying how the incremental build-up of cash value would be taxed in collateral split-dollar arrangements under § 83. The employee has always owned the policy, and the rollout did not precipitate a transfer of property from the employer. This fundamental flaw in the Service's position should be addressed by legislation and does not seem susceptible to cure by regulation. However, the Service may attempt to treat the arrangement as an interest-free loan, with the imposition of deemed interest payments each year regardless of how the parties formally characterize the relationship.
- Continue to use favorable insurer's term rates on split-dollar arrangements until mandated conversion to interest-free loan treatment in 2004. For split-dollar arrangements entered into after January 28, 2002 and before final guidance, the use of the insurer's term rates will be subject to more stringent standards.

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Portland, Oregon

Study of the Uniform Trust Code to Begin

A committee has been formed to study the new Uniform Trust Code (the "UTC") for possible adoption in Oregon. The UTC is the most comprehensive trust and estate legislation developed by the National Conference of Commissioners on Uniform State Laws since 1969, when the Uniform Probate Code was approved. Kansas has already adopted the UTC, and at least 30 states have study projects or legislative proposals pending.

Most states, including Oregon, have relatively few statutes governing trusts. Case law often is scarce, leaving trust beneficiaries, lawyers, trustees, and the courts to rely on the Restatement of Trusts and the multivolume treatises by Bogert and Scott. States that enact the UTC, or similar legislation, will be able to specify their rules on trust law with precision and in a readily available source. While some of the UTC's provisions merely state generally accepted trust law, the UTC does make some significant changes. The text of the UTC is available on-line at www.nccusl.org.

The UTC Study Committee is co-chaired by Professor Valerie Vollmar of Willamette University College of Law and Professor Susan Gary of the University of Oregon School of Law. Other members of the 12-person committee are Ron D. Bailey (Portland), Alan Bennett (Salem), Allyn Brown (Newberg), Rita Batz Cobb (Hillsboro), Penny Davis (Portland), Susan Grabe (Portland), Steve Lane (Eugene), Tim O'Rourke (Pendleton), Ken Sherman (Salem), and Jennifer Todd (Salem). Committee members were selected to allow involvement of the Elder Law Section, Estate Planning and Administration Section, and Taxation Section of the Oregon State Bar, as well as the Oregon Bankers Association, Oregon probate judges, and the Oregon State Bar's Public Affairs staff.

The committee began meeting in September 2002. Interested persons will be asked to present their views to subcommittees during the first half of 2003, and the committee itself will reconvene in fall 2003 to consider the subcommittees' recommendations. The committee's goal is to develop specific legislative proposals by April 2004, which can be considered by the Oregon legislature during the 2005 session.

If you would like to serve on a subcommittee or present your views on the UTC, please contact one of the cochairs:

Professor Valerie J. Vollmar
(503) 370-6079
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Professor Susan N. Gary
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Oregon Estate Tax Update

During the fifth special session both houses of the legislature adopted HB 4077 which makes a number of changes to the Oregon Estate Tax. On September 25, 2002, Governor Kitzhaber placed this bill on his list of potential vetoes. The Governor has until October 30, 2002 to decide whether or not to veto this bill.

If HB 4077 is allowed to pass, it will tie years 1998 through 2001 to the Taxpayer Relief Act of 1997. Thus, no additional taxes will be due for those years. For 2002 and 2003 the Oregon exemption will be increased to $1,000,000. As a result estates with a gross value of $1,000,000 will not owe any Oregon estate tax. However, for estates in excess of $1,000,000 Oregon will not follow the federal reductions in the state death tax credit. During 2002 the Oregon estate tax will be 1.33 times the amount of the state death tax credit shown on the Federal 706 estate tax return. For 2003 the tax will be 2 times the amount of the state death tax credit. During 2004 the exemption is increased to $1,500,000 and the tax will be 4 times the state death tax credit. On January 1, 2005, the Oregon estate tax is repealed.

As this Newsletter goes to press, Governor Kitzhaber has not decided whether or not he will veto the bill. If he vetoes the bill, 2002 estates with a gross value of $1,000,000 or more and a net taxable value of $600,000 or more will be subject to Oregon estate tax. For years 1998 through 2001, the ODR will continue to accept returns as previously issued; however, the ODR will continue to pursue the legislature for clarification and direction. For background information on these issues, see Jeffrey M. Cheyne, "Oregon Estate Tax Warning - ORS 118.010," *Or Est Plan & Admin Sec Newsl*, at 8 (Apr. 2002).

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Beaverton, Oregon

Interrelationship between the New State Death Tax Deduction and Income in Respect of a Decedent

Under the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub L No. 107-16, 2001 USCCAN (115 Stat 38)) ("EGTRRA"), the state death tax credit is gradually phased out and is replaced by a deduction for the estates of individuals who die after the year 2004. IRC §§ 2011, 2058. The credit is phased out in the following manner: for decedents dying in 2002, the credit is limited to 75 percent of the otherwise available credit; in 2003, the credit is limited to 50 percent; and in 2004, the credit is limited to 25 percent. IRC § 2011(b)(2). The deduction applies only to estates of individuals who die after 2004 and to generation-skipping transfers after 2004. The Internal Revenue Code limits the deduction to state death taxes actually paid by the estate, but otherwise places no cap on the deduction. IRC § 2058(a). Of course, the repeal of the state death tax credit does not increase or reduce the overall estate taxes if the state imposes only a death tax equal to the credit. The Internal Revenue Service has not yet promulgated regulations under § 2058.

To claim a deduction for state death taxes paid, the claim must be filed before the later of:

- Four years after the U. S. estate tax return has been filed;
- In the event of a timely filing of a Petition for Redetermination of an estate tax deficiency, 60 days after the relevant Tax Court decision becomes final;
- If an extension under IRC § 6161 or § 6166 has been granted as to the payment of estate tax, the date the extension period expires; or
- If a timely refund claim has been filed, then the latest of:
  - Sixty days from the mailing of a notice to the taxpayer of the disallowed claim;
  - Sixty days after the decision of a court becomes final regarding the claim; or
  - Two years after the Notice of Waiver of Disallowance is filed. IRC § 2058(b).

Although the generation-skipping transfer tax credit under IRC § 2604 is repealed after 2004, there is no state death tax deduction provision analogous to § 2058.

In light of these changes, the taxpayer is generally worse off due to the replacement of the state death tax credit by a deduction for state death taxes paid because a credit, unlike a deduction, has a dollar-for-dollar benefit.

One beneficial consequence of the repeal of the state death tax credit that mitigates its adverse effect on certain taxpayers is that because more transfer tax will be paid to the federal government and less to the state (even though the total federal and state death taxes paid remain the same in a "pick-up tax" state), there will be an increase in the income tax deduction under IRC § 691(c) for federal estate tax paid on "income in respect of the decedent." The § 691(c) deduction will be greater due to the new deduction from federal estate tax for state death taxes paid than it would be with the prior allowed state death tax credit against federal estate taxes. Even before 2005, the deduction will be greater because of the immediate phaseout of the amount of the state death tax credit. Further, due to the decreasing estate tax rate, taxpayers may receive a larger § 691(c) deduction in 2004 than in 2005. However, as states continue to scramble to de-couple from the rising unified credit exemption of the federal government, and as Oregon is already seeking to distance itself from the new tax law relative to the amount of the exemption, the increase in the § 691(c) deduction gives some relief to taxpayers that is greater after 2005 than today, but in a given case, could be greater in the year 2004. Accordingly, in assessing the initially negative tax impact of the repeal of the credit for state death taxes paid, the increased § 691(c) deduction may, in a given case, be a significant tax benefit that should not be overlooked.

Joseph J. Hanna, Jr.
Hanna Strader P.C.
Portland, Oregon

New Estate Planning Section Officers

The following slate of officers has been nominated for the coming year:

Chair - Bernie Vail
Chair Elect - Richard Pagnano
Past Chair - Ron Bailey
Treasurer - Chris Cline
Secretary - Jim Cartwright

Two-Year Members at Large - Karen Allan, Mary Chaffin, Shannon Connelly, Jonathan Levy, David Paulson, Anne Thompson, Eric Vetterlein.

Continuing Members at Large - William Brewer, Susan Gary, Lauren Holland, Michael Sandoval, Tim Wachter, Theresa Wade.

CALENDAR OF SEMINARS AND EVENTS

- October 11, 2002 (Sponsored by Oregon State Bar) **Elder Law**, Oregon Convention Center, Portland, OR. Telephone: (503) 684-7413.

- October 20-25, 2002 (Sponsored by New York University) **61st Institute on Federal Taxation**, The Plaza Hotel, New York City, NY. Telephone: (212) 998-7171.

- October 27-31, 2002 (Sponsored by Chaminade University Tax Foundation and Chaminade University of Honolulu) **The 39th Annual Hawaii Tax Institute**, Sheraton Moana Surfrider Hotel, Honolulu, HI. Telephone: (615) 880-4200.

- October 31-November 1, 2002 (Sponsored by PLI) **33rd Annual Estate Planning Institute**, PLI California Center, San Francisco, CA. Telephone: (800) 260-4PLI.

- November 7-9, 2002 (Sponsored by National Association of Estate Planners and Councils) **39th Annual Conference**, Wyndam Harbour Island Hotel, Tampa, FL. Telephone: (610) 526-1462.

- November 14-15, 2002 (Sponsored by the WSBA) **The 47th Annual Estate Planning Seminar**, Washington State Convention and Trade Center, Seattle, WA. Telephone: (800) 945-WSBA.

- November 16, 2001 (Sponsored by The Law School University of Southern California Law School) **Twenty-Seventh Annual Probate and Trust Conference**, Western Bonaventure Hotel, Los Angeles, CA. Telephone: (213) 740-2582.

- November 18-22, 2002 (Sponsored by ALI-ABA) **Planning Techniques for Large Estates**, San Francisco, CA. Telephone: (800) CLE-NEWS.

- November 20, 2002 (Sponsored PLI) **Understanding Estate, Gift & Fiduciary Income Tax Returns 2002: Post-EGTRRA Strategies for Maximum Advantage with the "706" "709" and "1041**," PLI New York Center, New York, NY. Telephone: (800) 260-4PLI.

- December 5, 2002 (Sponsored by Oregon State Bar) **Planning the Basic Estate**, Oregon Convention Center, Portland, OR. Telephone: (503) 684-7413.

- January 6 - 10, 2003 (Sponsored by University of Miami School of Law) **Thirty-Seventh Annual Philip E. Heckerling Institute on Estate Planning**, Fontainebleau Hilton Resort & Towers, Miami Beach, FL. Telephone: (305) 284-6276.

- January 24, 2003 (Sponsored Estate Planning Council of Portland) **Annual Estate Planning Seminar**, Oregon Convention Center, Portland, OR. Telephone: (503) 244-4294.

- January 27-29, 2003 (Sponsored by The Law School University of Southern California Law School) **Institute on Federal Taxation**, The Wilshire Grand Hotel, Los Angeles, CA Telephone: (213) 740-2582.

- February 20-22, 2003 (Sponsored by ALI-ABA) **Advanced Estate Planning Techniques**, Maui, HI. Telephone: (800) CLE-NEWS.

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