Navigate the Parallel Tax Rules of IRAs and Annuities

A 10% penalty can apply to early distributions from both IRAs and tax-deferred annuities, but some tax computations and distribution requirements differ between the two.

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In the journey of planning and administering estates and trusts that include assets in traditional individual retirement accounts (IRAs) and nonqualified tax-deferred annuities (annuities), the planning professional often finds him or herself in two parallel universes. While the rules governing the lifetime use and post mortem distribution of each often echo one another, they also each carve out their own idiosyncrasies. Knowing where those rules align and where they chart their own paths is critical to analyzing, planning, and administering such estates and trusts. This article gives an overview of what the rules say and what to do once traditional IRAs and annuities are funded, looking at life before age 59½, life after reaching 59½, and post mortem issues. As the article focuses exclusively on the rules applicable to traditional IRAs and annuities that are not part of a qualified retirement plan, it does not explore the tax rules governing Roth IRAs and annuities under a qualified retirement plan as defined in Section 4974(c).

Life before 59½

Prior to reaching age 59½, owners of both IRAs and annuities are subject to an assumed 10% penalty. However the rules for each arise under different Code sections with different exceptions.

Early distributions from IRAs. IRAs are treated the same as other qualified retirement plans.[1] In general, income earned in a qualified retirement plan is not taxable to the employee/plan participant.[2] Distributions made from an IRA, however, are generally subject to income tax and a 10% penalty.[3] But, that penalty, as it relates to IRAs, is subject to at least 14 exceptions, as follows:

(1) Distributions that occur after the owner attains age 59½.

(2) Distributions made on or after the owner's death, to the owner's beneficiary or to the owner's estate.

(3) Distributions attributable to the owner being disabled.

(4) Distributions that are part of a series of substantially equal periodic payments "made for the life (or life expectancy) of the owner or the joint lives (or joint life expectancies) of such owner and his designated beneficiary."

(5) Distributions made on account of a Section 6331 levy.

(6) Distributions for medical expenses of an unemployed owner allowed under Section 213.

(7) Distributions to unemployed owners for payment of health insurance premiums.

(8) Certain distributions made for higher education expenses.

(9) Certain distributions used for the purchase of a first home.

(10) Distributions to owners who are called up to active duty military service for over 179 days or indefinitely.[4]

(11) Distributions in what is otherwise a tax-free rollover or trustee-to-trustee transfer.[5]

(12) Distributions to a former spouse under a valid divorce decree or a written instrument incident to divorce.[6]

(13) Timely distributions of nondeductible contributions and excess contribution amounts.[7]

(14) Qualified HSA funding distributions.8

Early distributions from annuities. Like IRAs, annuities also allow for tax-free growth within the contract.[9] However, any distribution from the contract is subject to a 10% penalty.[10] The penalty is subject to at least 11 exceptions, as follows:

(1) Distributions that are made after the holder turns 59½.

(2) Distributions paid on or after the death of the holder of the annuity, or the primary annuitant, if the holder is not an individual.

(3) Distributions paid due to the holder's disability.

(4) Distributions that are part of substantially equal periodic payments "made for the life (or life expectancy) of the taxpayer or the joint lives (or joint life expectancies) of such taxpayer and his designated beneficiary."

(5) Distributions from qualified retirement plans.

(6) Distributions that are allocated to investment in the contract before 8/14/1982.

(7) Distributions from certain annuities assigned to pay damages for personal injury or worker's compensation.

(8) When Section 72(t) otherwise applies.

(9) Distributions under immediate annuity contracts.

(10) Distributions from annuities purchased by an employer for an employee at the time a qualified plan is terminated and payable until the employee separates from service.[11]

(11) Tax-free exchanges under Section 1035.[12]

Thus, for distributions during life but before age 59½, an IRA or an annuity owner must negotiate a labyrinth of exceptions to avoid the 10% penalty. That notwithstanding, the fact that there are at least 14 exceptions for IRAs and 11 exceptions for annuities means a client who must take money from his or her IRA or annuity has plenty of options.

Taxation of early distributions. Early distributions are generally taxable under Section 72. However, the manner of the taxation differs between the two types of assets. Early distributions from IRAs have a nontaxable component based on a ratio:

Nontaxable portion = Distribution × (Investment in the contract / Account balance).[13]

An IRA owner has no investment in the contract, however, unless the contributions were nondeductible.[14]

Early distributions from an annuity, on the other hand, will be taxed as "an amount not received as an annuity."[15] An amount received from an annuity contract that is received prior to the contract's annuitization or in excess of the allowed annuity payment after annuitization, is an amount not received as an annuity.[16] Amounts not received as an annuity are taxed using a LIFO method, including the entire distribution amount in the taxpayer's gross income to the extent the distribution does not exceed the difference between the contract's cash surrender value and the investment in the contract.[17]

Example 1. Post-1986, Bob contributes $10,000 to an annuity, in a year when he could deduct $5,000 for IRA contributions. After ten years, when Bob is younger than 59½ and the cash surrender value of the contract is $20,000, Bob withdraws $10,000. Bob's taxable portion of that withdrawal is $10,000, because the difference between the cash surrender value and the investment in the contract is $10,000. Bob must recognize income up to $10,000, under the LIFO scheme.

Suppose instead Bob had made the initial contribution to an IRA, and took a withdrawal of the same amount at the same time, when the IRA balance was $20,000, Bob's taxable portion would also be $10,000. If, however, Bob's contribution to the IRA had been nondeductible, his withdrawal of $10,000 would have a nontaxable portion of $2,500 [$10,000 × ($5,000/$20,000)] and a taxable portion of $7,500.

Thus, an IRA distribution could include a return of investment (tax-free) portion, while the same distribution from an annuity may not. The 10% penalty would then apply to the amount that is includable in gross income,[18] which as noted, could be greater for an annuity distribution, than for an IRA distribution.

While the plan documents or annuity contract ultimately control, one caution for annuities is that early distributions may obviate spousal rights or other benefits under the contract. These sorts of penalties may not apply in the case of an IRA.

Life after 59½

For 10% penalty purposes, a person enters a sort of "no-man's land" when reaching age 59½. The IRA owner is free to take money out of his or her account, without tax penalty. At the same time, the annuity owner, depending on his or her contract, may be able to take money out of his or her contract, and where allowed, also can do so without tax penalty. Unlike the annuity owner, however, the IRA owner's life becomes more complicated at age 70½ For someone at that age, the rules for IRAs and annuities begin to deviate substantially.

Required minimum distributions during life. Starting on the required beginning date, IRA plans have to require the IRA owner to withdraw all of the owner's account or take out the account balance over the owner's lifetime.[19] Most plans allow their IRA owners to use the over-the-life method, otherwise known as required minimum distributions (RMDs). The required beginning date is April 1 of the year after the year in which the IRA owner turns 70½.[20]

The RMD amount that must be distributed each year is determined by dividing the account balance by the applicable distribution period.[21] The account balance is the value of the account on the last day of the year prior to the year in which the distribution is made.[22] The applicable distribution period is a period indicated in IRS tables based on the owner's age in the year for which the distribution is made.[23] If the IRA owner's spouse is not the sole designated beneficiary of the IRA, or is the sole designated beneficiary but is not more than ten years younger than the owner, then the Uniform Lifetime Table is used.[24] If the spouse is the sole beneficiary and more than ten years younger than the owner, then the Joint and Last Survivor Table is used.[25] Otherwise, the Single Life Table is used.[26]

All distributions of RMD are taxed under Section 72.[27] Thus, the distribution is subject to the rules discussed above. If the IRA owner fails to withdraw the entire required amount by April 1 of the year following the year in which he or she turned 70½, or December 31 of the end of all subsequent years, then a 50% excise tax is imposed on the shortfall.[28]

Example 2. Bob has an IRA with an account balance on December 31 of year 1 of $1 million. Bob named his wife, who is not more than ten years younger than him, as the sole designated beneficiary of the IRA. Bob turned 70½ in year 1. On April 1 of year 2, Bob's risky investing has left his IRA balance at only $900,000. Regardless, Bob must take an RMD payment on April 1 of year 2 based on the $1 million account balance, and he uses the Uniform Lifetime Table to determine the required minimum distribution amount. His RMD on April 1, year 2 is $36,496 ($1,000,000 / 27.4).

Annuities after 59½. Because the ability to or requirement of receiving payments from the annuity are dependent on the contract terms, it is difficult to generalize. If the contract provides or proscribes annuitization after a particular term of years or age, then distributions are taxed, to the extent they equal the annuity amount, as amounts received as an annuity.[29]

Amounts received as an annuity are included in gross income based on the following formula:

Amount distributed × (Investment in the contract / Expected return).[30]

The determination of how to calculate the "investment in the contract" and the "expected return" is a complicated tangle of regulatory rules. Generally, investment in the contract is the amount the taxpayer contributes to the annuity, less any nontaxable portion received in prior annuity payments.[31] The expected return is an actuarial number derived from IRS Tables based on the type of contract, the age of the annuitant, and the frequency of payments.[32] Suffice it to say that each payment includes a taxable portion and a nontaxable portion.[33]

Any amount in excess of the annuity amount on an annuitized contract, or any amount received on a nonannuitized contract, is subject to the LIFO taxation discussed above.[34]

Death before 70½

Death is in some ways the great unifier of the IRA and annuity rules, each again mirroring the other, although with their own intricacies. Each makes a distinction between distributions before the "required beginning date" (i.e., 70½) for IRAs or before the "annuity starting date" (i.e., whatever date is stated in the contract for annuitization to begin) for annuities, and distributions after such dates.

RMD for death before required beginning date. If an IRA owner dies before his or her required beginning date, the two possibilities for taking distributions are:

(1) The five-year rule.

(2) RMDs.

The five-year rule is the default rule, and it provides that the entire account balance must be paid out by the end of five years from the date of the owner's death.[35] The exception to the five-year rule applies where the owner named designated beneficiaries and the plan administrator allows for RMDs instead.[36]

Determining designated beneficiaries. A designated beneficiary is any "individual designated as a beneficiary by the [IRA owner]."[37] The beneficiary can either be designated by the plan (if it allows for this) or, more likely, by an affirmative election. The beneficiary does not have to be individually named so long as he or she is identifiable.[38] Thus, naming one's "spouse" or "children" would typically suffice.

Because a designated beneficiary must be an "individual," estates or charities cannot be designated beneficiaries.[39] Naming a non-individual results in the IRA being deemed to lack any designated beneficiary, triggering the default five-year rule.[40]

Trusts may be allowed as designated beneficiaries. Certain trusts are ignored and the underlying beneficiaries treated as the designated beneficiaries ("look-through trusts"). A trust is a look-through trust if:

(1) It is valid under state law.

(2) It is irrevocable or will be irrevocable on the owner's death.

(3) It has beneficiaries who are identifiable.

(4) The trust meets the plan documentation rules by giving the IRA administrator a copy of the trust or list of beneficiaries.[41]

Only contingent beneficiaries count when determining who the designated beneficiaries are and in determining whose lives matter for purposes of calculating the RMD.[42] Contingent beneficiaries do not include successor beneficiaries, who are beneficiaries who cannot benefit from the IRA "beyond being a mere potential successor to the interest" of another beneficiary.[43] If the trust can accumulate any income, even theoretically, then the remainder beneficiaries are contingent beneficiaries, because their interest in principal goes beyond a mere expectation that a previous beneficiary will not use up all the trust property.[44] Conversely, if the trust provides that all income must be paid out to the current beneficiary, then remainder beneficiaries are only successor beneficiaries and are not taken into account as designated beneficiaries or lives that count for RMD purposes.[45] The application of the contingent beneficiary rules is strict and can have dramatic effects.

Example 3. Bob names a trust that will be irrevocable on his death as the beneficiary of his IRA. Bob dies before he turns 70½. The trust qualifies as a look-through trust. Under Bob's trust agreement, his wife is the primary beneficiary, and the trust agreement states that the trustee is to distribute the RMD amount to her outright, each year. On Bob's wife's death, the trust is payable to Charity, Inc. (a Section 501(c)(3) organization). Because the trust agreement does not require all income to be paid out to Bob's wife each year, Charity, Inc. is a contingent beneficiary. Because Charity, Inc. is a contingent beneficiary, it is counted in determining designated beneficiaries. The naming of a non-individual beneficiary causes the IRA to be deemed to have no beneficiaries, and the five-year rule will apply when Bob dies.[46]

Example 4. The facts are the same as in Example 3, except the trust provides that at Bob's death, his two children will be the beneficiaries of the trust. The trustee may accumulate undistributed income. Each child has a testamentary limited power of appointment to appoint property to anyone other than himself or herself, his or her estate, his or her creditors, and the creditors of his or her estate. Because a charity could be the taker under the power of appointment, a non-individual is a contingent beneficiary. As a result, Bob's IRA is deemed to have no designated beneficiary, and the five-year rule applies on Bob's death.[47]

Last, the identities of who counts as a designated beneficiary are determined on September 30 of the year after the year of the IRA owner's death.[48] So, in Example 3, Bob's wife could buy the interest of Charity, Inc. before that deadline to make herself qualify as the sole spousal beneficiary of the IRA.[49] Likewise, in Example 4, Bob's children could make a partial disclaimer or partial release of their power of appointment as to non-individuals and as to individuals who are older than the power holder.[50]

Calculating RMDs. After the designated beneficiaries are determined, the RMD rules are applied to the appropriate life expectancies. A surviving spouse who is the sole designated beneficiary (i.e., the only beneficiary other than successor beneficiaries), can either use the deceased spouse's age, roll the account into his or her own IRA (then use his or her own age), or elect to treat the existing IRA as his or her own account (using his or her own age).[51] The election option is available only if the surviving spouse is the sole beneficiary and has total discretion to make withdrawals, and the election does not apply if the beneficiary is a trust.[52] Thus, if either the deceased spouse or the surviving spouse was under age 70½ on the date of the deceased spouse's death, the surviving spouse can defer commencing RMDs until the deceased spouse would have turned, or the surviving spouse actually does turn, 70½. If the surviving spouse's life expectancy is used, he or she is allowed to re-determine his or her life expectancy each year, resulting in greater tax deferral.[53]

Nonspousal beneficiaries and spousal beneficiaries who are not sole beneficiaries, must begin taking RMD payments by the end of the year after the year in which the IRA owner died.[54] These payments are made using the age of the oldest individual of the group of beneficiaries.[55] However, a surviving spouse still has the option to roll the surviving spouse's share into the surviving spouse's own account.[56] If the designated beneficiary is a look-through trust, the age of the oldest current or contingent beneficiary of the trust is used.[57] If a surviving spouse is the sole beneficiary of a look-through trust that is the designated beneficiary of an IRA, in some instances, the IRS has privately ruled that the surviving spouse may roll the IRA into the surviving spouse's own account. [58]

If the account is split into separate accounts by December 31 of the year following the year of the IRA owner's death, then the life expectancy of the oldest person on each account (assuming the accounts benefit different people) is the life expectancy used ("separate accounts rule").[59] The separate accounts rule cannot be applied if a trust is named as a designated beneficiary.[60] That is, the IRS will not look through the trust to apply the separate accounts rule. However, the separate accounts rule can be applied if individual trusts for different beneficiaries are named as the designated beneficiaries. [61] In any case, the life expectancy of the oldest beneficiary is determined in the year of the IRA owner's death, and the factor from the life expectancy tables is reduced by one each year thereafter, resulting in less tax deferral than for a sole beneficiary surviving spouse.[62]

Annuitant's death before annuity starting date. If an annuitant dies prior to the annuity starting date, distribution requirements similar to RMDs are triggered. The annuity starting date, or the day the contract will begin to make annuity payments, is typically a matter of contract law.[63] The default distribution rule, as with IRAs, is the five-year rule.[64] The exception, as with IRAs, is a designated beneficiary.[65]

For annuities, designated beneficiaries are defined as "any individual designated a beneficiary."[66] There is no equivalent to the IRA rules of look-through trusts. Instead, one who wants a trust to be a designated beneficiary would have to ensure the trust was grantor to the beneficiary he or she intends to use in order to avoid the five-year rule.[67]

If a surviving spouse is named as a designated beneficiary, whether solely so or not, the surviving spouse's share of the contract is treated as if he or she were the annuity owner. [68] Thus, he or she would have the right to defer annuitization of the contract just as the annuity owner could have during the owner's life. Other designated beneficiaries must receive the contract amount in annuities over their respective life expectancies. [69] If the contract provides that the holder could defer annuitizing the contract indefinitely, then the designated beneficiaries could also defer annuitization.

The annuity rules mandate the use of the separate accounts rule.[70] Thus, if a nongrantor trust, the surviving spouse, and a child are all named as beneficiaries in equal shares, then, under the rule, each should be treated separately as to the applicable 1/3 interest in the contract. As such, the trust would be subject to the five-year rule, the spouse could be treated as the annuity owner, and the child could take his or her 1/3 out over his or her life expectancy. Of course, all of this is subject to the terms of the annuity contract. Additionally, each beneficiary should be able to make a Section 1035 exchange of his or her own 1/3 share of the contract.[71]

Each nonspousal beneficiary must begin taking payments from the contract within one year of the annuitant's date of death.[72] Unlike IRAs, however, no rule prescribes when the identities of the designated beneficiaries are determined. It is possible that the identities of beneficiaries must be determined one year after the annuitant's death. As with IRAs, one can rely on disclaimers to remove and add beneficiaries. In states that have adopted the Uniform Disclaimer of Property Interests Act, such a disclaimer can be made anytime, regardless of whether it is a qualified disclaimer for tax purposes under Sections 2046 and 2518.[73] Thus, conceivably, the identity of beneficiaries could change more than a year after the annuitant's date of death, by a beneficiary's disclaimer. How an insurance company would treat a disclaimer after payments have begun depends on the policies of each individual company.

Death after 70½

The game changes somewhat if the IRA owner dies after the required beginning date (age 70½) or if the annuitant dies after the annuity starting date.

RMD for death after required beginning date. For IRAs, after the required beginning date, only the RMD rules apply and the five-year rule does not apply.[74] The critical question is not necessarily whether a designated beneficiary is named, but which beneficiary's life is the longest. The general rule is RMDs must be distributed based on the longer of the life expectancy of the oldest designated beneficiary (or the surviving spouse if he or she is the sole designated beneficiary) and the life expectancy of the IRA owner.[75] The separate accounts rule still applies, as do the rules regarding contingent and successor beneficiaries and trusts as designated beneficiaries.

The surviving spouse who is the sole designated beneficiary may still elect to treat the IRA as his or her own, or to roll over the IRA into his or her own IRA.[76] If the surviving spouse decides to take RMDs, the surviving spouse is allowed to use the longer of his or her life expectancy or the deceased spouse's life expectancy when calculating RMD amounts.[77] If the deceased spouse's life expectancy is used, the life expectancy is determined once in the year of death, and then reduced by one in each subsequent year.[78] If the surviving spouse's life expectancy is used, the life expectancy is re-determined each year.[79]

If there is a nonspouse designated beneficiary, or the surviving spouse is not the sole designated beneficiary, then the longer of the IRA owner or the oldest designated beneficiary's life expectancy is used.[80] However, the life expectancy is determined once in the year of the IRA owner's death, and then reduced by one for each subsequent year.[81] If there is no designated beneficiary, then the IRA owner's life expectancy is used in the same manner, reducing it by one for each subsequent year.[82] Once again, the surviving spouse also has the rollover option.[83]

Annuitant's death after annuity starting date. As with IRAs, once the annuity starting date has passed, the five-year rule no longer applies.[84] Instead, the entire contract amount must be distributed at least as rapidly as under the method used by the holder on his or her date of death (payout rule).[85] Like the five-year rule, the exception to the payout rule is a named designated beneficiary.[86] Of course, a designated beneficiary who is older than the annuity owner might want to use the method of distribution of the holder.

Whether the distributions are made on the owner's method, over the designated beneficiary's life time, or by some other means, is often determined by the insurance company. In at least one case, the Service has blessed the use of any of the three methods of distribution for a series of substantially equal periodic payments, under Rev. Rul. 2002-62,[87] for calculating the lifetime distributions of an annuity beneficiary.[88]

Again, the surviving spouse is treated as stepping into the shoes of the holder of the annuity contract.[89] Thus, if the contract allowed it, the surviving spouse could continue deferral of payments.

Other estate planning considerations

In planning for the goals of lifetime and post mortem tax deferral, one also must consider the special rules relating to choice of ownership, lifetime transfers, marital planning, and charitable planning.

Choice of ownership. IRAs are defined as "a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries."[90] Thus, while one can name an entity as a beneficiary of an IRA, an entity cannot be the owner of an IRA.

Generally, the same is true for annuities. Trusts are typically barred from owning annuity contracts.[91] The three exceptions to this rule are as follows:

(1) Grantor trusts.

(2) Nongrantor trusts that are agents of a natural person.

(3) A contract obtained by the estate of the deceased owner by reason of the owner's death; a contract that is held under a Section 401(a), 403(a), or 403(b) plan or annuity; certain annuities assigned to pay damages for personal injury or worker's compensation; annuities purchased and held by an employer for employees on the termination of a Section 401(a) or 403(a) plan; and immediate annuities.[92]

A nongrantor trust is an agent of a natural person if the trustee holds only nominal ownership in the contract, and individuals hold all of the beneficial ownership.[93] Violation of these rules causes the annuity to cease to be an annuity contract and triggers acceleration of all income in the annuity.[94]

Lifetime transfers. For both IRAs and annuities, lifetime transfers can have potentially devastating tax consequences. In limited circumstances, however, transferring an ownership interest in an IRA or annuity may make sense.

The transfer of an IRA is a deemed distribution of the account balance to the transferor, then a gift from the transferor to the transferee of that amount.[95] The entire account balance is usually subject to the 10% early distribution penalty and to income taxation[96] because the transferor typically has a basis in the IRA of zero.[97] The transferee receives a zero basis in the IRA.[98]

Although the Section 2035 "three-year rule" does not apply to annuities and other payments, thus placing the transfer out of the transferor's gross estate, if the transferor retains any of the IRA, or a reversion, or the right to amend or revoke the transfer, then the IRA could fully be included in the transferor's estate under Sections 2036, 2037, and 2038.[99] The three-year rule provides that a decedent's gross estate includes the value of (1) any property the decedent transfers (or releases a power in) that would otherwise have been included in the decedent's gross estate under Section 2036 through 2038, or 2042; or (2) any gift taxes the decedent or the decedent's estate paid, within three years prior to the decedent's date of death.

Annuities that are transferred for less than adequate consideration are deemed a distribution of the contract, and thus the annuity owner must recognize income equal to the surrender value of the contract less the investment in the contract (income acceleration rule).[100] The income acceleration rule does not apply to transfers to a spouse or former spouse incident to a divorce.[101] Unlike the IRA transferee, however, the transferee of an annuity subject to the income acceleration rule receives an investment in the contract that is increased by any amount of the contract that was included in the transferor's gross income.[102] Like an IRA, a transferred annuity would typically not be subject to inclusion in the transferor's gross estate under the Section 2035 three-year rule.[103]

Recently the IRS privately ruled that a transfer of an annuity from a trustee to a beneficiary was not subject to the income acceleration rule.[104] In that ruling, the trustee proposed to purchase an annuity for each of the beneficiaries. Each beneficiary would be an annuitant of the beneficiary's individual contract held in trust. The trustee would then transfer each annuity to the respective beneficiary. The IRS reasoned that because the annuitant and beneficiary did not change when the contract would be transferred to the annuitant beneficiary, the income acceleration rule was not applicable.[105]

Marital planning. With both IRAs and annuities, naming a spouse as the sole beneficiary provides the maximum flexibility. IRAs that are left outright to a spouse are eligible for the estate tax marital deduction, because they are direct, unrestricted transfers.[106] IRAs left to a trust could qualify for the estate tax marital deduction under one of two situations:

(1) The trust is a power of appointment trust.

(2) The trust is structured so that it qualifies for the QTIP election.[107] Although trusts may qualify for an estate tax marital deduction, any accumulated RMD in excess of income could cause contingent beneficiaries to be included in the RMD calculation.[108]

For annuities, any portion under which the surviving spouse is a designated beneficiary should be eligible for the estate tax marital deduction.[109] Where the annuity is a joint and survivor annuity, there is an automatic QTIP election.[110] Because the separate accounts rule is mandated by the Code, there is no need to worry about contingent beneficiaries ruining any of the benefits to leaving the annuity to a spouse.[111] Although there is no rollover, per se, for annuities, the surviving spouse should be able to make a Section 1035 exchange of his or her share of the contract, because the surviving spouse is treated as though he or she is the decedent spouse.[112]

Charitable planning. Because amounts that come out of IRAs and annuities are income in respect of a decedent (IRD), leaving IRAs or annuities to charities is a very tax-efficient strategy.[113]

IRAs that name charities must confront the five-year rule. If any charity is a named beneficiary or a contingent beneficiary, the entire IRA will be deemed to have no designated beneficiary.[114] Thus, naming charities as residuary or remainder beneficiaries of trusts named as designated beneficiaries that may (even theoretically) accumulate any income causes the IRA to have no designated beneficiary.[115] The Service has privately ruled that the possibility that a charity could be a permissive appointee under a power of appointment makes a charity a contingent beneficiary.[116] In that ruling, the Service ignored a state court reformation of the trust power of appointment that excluded charities, reasoning that without specific authority to reform under the Code or the regulations, the Service should ignore a state court order.

Payment of pecuniary bequests to charities from IRAs can also cause recognition of income to the estate or trust[117] and may not allow the estate or trust an income tax charitable deduction if the distribution is not directed to be made from income.[118] Likewise, if the trust or will directs the payment of a charitable bequest from the residue, the estate or trust, on collecting the distribution, would have IRD and may not qualify for an income tax charitable deduction for paying the bequest (although there would be an estate tax charitable deduction).

Lifetime contributions to charities can be made tax-free if the distribution is not over $100,000, the moneys are contributed to a qualified charity in the year of distribution (which year is between 1/1/2006 and 12/31/2011), and the IRA owner is at least 70½ years old at the time of the distribution.[119]

Annuities that name charities are not fully subject to the five-year rule if at least one other beneficiary is an individual. As discussed, this is because the separate accounts rules are mandated for annuities. As with IRAs, however, a pecuniary bequest to a charity from an annuity could cause income to the estate or trust without the possibility of a charitable deduction.[120]

Conclusion

The rules relating to lifetime and post-mortem distributions and transfers of IRAs and annuities often follow parallel roads. In order to effectively advise clients who own these assets, the estate planner must be able to navigate each road. While the rules can be strikingly similar, they also can drastically differ. The same action with one can end in markedly different results than with the other. Consequently, knowing these rules and where they diverge is essential to helping clients meet their ultimate goals.

Exhibit 1: IRA and Annuity Distribution and Timing

LIFETIME		
	IRA	**ANNUITY**
10% early distribution penalty	Distribution before age 59½ unless Section 72(t)(2) exception.	Distribution before age 59½ unless Section 72(q)(2) exception.
Required beginning/starting date	April 1 of year after employee turns 70½.	Contract determinative.
Distribution after 59½ but before required beginning/ starting date	Take distribution anytime (if allowed by contract); taxed as amount not received as an annuity.	Take distribution anytime (if allowed by contract); taxed as amount not received as an annuity.
Distribution after required beginning/starting date	RMD calculated on employee's (and potentially joint/uniform lives), taxed as amount received as an annuity, exclusion ratio determined.	Taxed as amount received as an annuity, exclusion ratio determined.

DEATH		
	IRA	**ANNUITY**
Determining designated beneficiaries	September 30 of year following year of employee's death.	None.
First payment	RMD must begin by December 31 of year following year of employee's death.	Unless contract can be deferred, payments must begin one year after holder's death.
Death occurring before required beginning/starting date	*Surviving spouse sole beneficiary:* Elect to treat IRA as his or her own, step into shoes of employee, or take RMD by end of year following death. *Others:* RMD by end of year following death.	*Surviving spouse:* Treated as if the holder; take distributions when holder would *Others:* Take distribution within one year of death.
Death occurring after required beginning/starting date	*Surviving spouse sole beneficiary:* Elect to treat IRA as his or her own, step into shoes of employee, or take RMD by end of year following death. *Others:* RMD by end of year following death.	*Surviving spouse:* Treated as if the holder; take distributions when holder would *Others:* Take distribution within one year of death.

Endnotes

[1] See Section 4974(c); Reg. 54.4974-2, Q&A-2.

[2] See, e.g., Reg. 1.408-1(b) (stating IRAs and individual retirement annuities are "exempt from all taxes under subtitle A of the Code other than taxes imposed under section 511").

[3] Section 72(t)(1).

[4] See Section 72(t)(2).

[5] Section 408(d)(3).

[6] Section 408(d)(6) and Reg. 1.408-4(g)(1).

[7] Sections 408(d)(4) through (5).

[8] Section 408(d)(9).

[9] See Section 72(a).

[10] Section 72(q)(1).

[11] See Sections 72(q)(2)(A) through (J).

[12] See Sections 72(q)(1) and 1035(a).

[13] Section 72(e)(8)(B).

[14] See Schmalzer, TCM 1998-399.

[15] See Section 72(e)(1)(A).

[16] Section 72(e)(1)(A).

[17] Section 72(e)(2)(B) (as to contracts issued after 8/14/1982 and not received in a Section 1035 exchange).

[18] Sections 72(q)(1) and 72(t)(1).

[19] See Section 401(a)(9)(A); Regs. 1.401(a)(9)-1 Q&A-1 and 1.408-8 Q&A-1.

[20] Section 401(a)(9)(C)(ii)(II) and Reg. 1.401(a)(9)-2, Q&A-2(a).

[21] Reg. 1.401(a)(9)-5, Q&A-1.

[22] Reg. 1.401(a)(9)-5, Q&A-3(a).

[23] Reg. 1.401(a)(9)-5, Q&A-4(a).

[24] Reg. 1.401(a)(9)-9, Q&A-1.

[25] Reg. 1.401(a)(9)-9, Q&A-2.

[26] See Reg. 1.401(a)(9)-9, Q&A-3.

[27] Sections 72(e)(8) and 408(d).

[28] Section 4974(a).

[29] See Sections 72(a) and (b).

[30] Section 72(b).

[31] Reg. 1.72-6(a)(1).

[32] See Reg. 1.72-5.

[33] Section 72(b).

[34] Section 72(e)(2)(B).

[35] Section 401(a)(9)(B)(ii); Reg. 1.401(a)(9)-3, Q&A-2.

[36] Section 401(a)(9)(B)(iii); Reg. 1.401(a)(9)-3, Q&A-4(b).

[37] Section 401(a)(9)(E).

[38] Reg. 1.401(a)(9)-4, Q&A-1.

[39] Reg. 1.401(a)(9)-4, Q&A-3 and -5.

[40] Reg. 1.401(a)(9)-4, Q&A-3.

[41] Reg. 1.401(a)(9)-4, Q&A-5(b).

[42] Reg. 1.401(a)(9)-5, Q&A-7(b).

[43] Reg. 1.401(a)(9)-5, Q&A-7(c).

[44] See Reg. 1.401(a)(9)-5, Q&A-7(c)(3), Example 1.

[45] See Reg. 1.401(a)(9)-5, Q&A-7(c)(3), Example 2.

[46] See Reg. 1.401(a)(9)-4, Q&A-3.

[47] See Ltr. Rul. 201021038.

[48] Reg. 1.401(a)(9)-4, Q&A-4(a).

[49] If the contingent beneficiary child buys the interest of the surviving spouse, the rules of Section 2519 could come into play.

[50] See Sections 2514(b) and 2518(a).

[51] See Section 402(c)(9); Regs. 1.401(a)(9)-5, Q&A-5(c)(2) and 1.408-8, Q&A-5(a).

[52] Reg. 1.408-8, Q&A-5(a).

[53] See Reg. 1.401(a)(9)-5, Q&A-5(b) and (c).

[54] Reg. 1.401(a)(9)-3, Q&A-3(a).

[55] Reg. 1.401(a)(9)-5, Q&A-7(a)(1).

[56] Reg. 1.402(c)-2, Q&A-12(a).

[57] See Regs. 1.401(a)(9)-4, Q&A-5(a) and 1.401(a)(9)-5, Q&A-7(a)(1).

[58] See Ltr. Ruls. 200940031 and 200245055.

[59] Reg. 1.401(a)(9)-8, Q&A-2(a)(2).

[60] Reg. 1.401(a)(9)-4, Q&A-5(c).

[61] See Reg. 1.401(a)(9)-4, Q&A-5(c) and Ltr. Rul. 200317041.

[62] See Regs. 1.401(a)(9)-5(b) and (c).

[63] See Reg. 1.72-4(b)(1).

[64] Section 72(s)(1)(B).

[65] Section 72(s)(2).

[66] Section 72(s)(4).

[67] See Rev. Rul. 85-13, 1985-1 CB 184.

[68] Section 72(s)(3).

[69] Section 72(s)(2)(B).

[70] See Section 72(s)(2)(A) (stating that the exception to the five-year rule applies to "any portion of the holder's interest [that] is payable to ... a designated beneficiary.").

[71] See Section 1035(a); Rev. Rul. 2003-76, 2003-2 CB 355; Rev. Proc. 2011-38, 2011-30 IRB 66 .

[72] Section 72(s)(2)(C) (for beneficiaries not electing a five-year payout under Section 72(s)(1)(B)).

[73] See UDPIA sections 5 and 12 (2006).

[74] See Regs. 1.401(a)(9)-3, Q&A-1(a) and 1.401(a)(9)-5, Q&A-5(a).

[75] Reg. 1.401(a)(9)-5, Q&A-5(a).

[76] See Section 402(c)(9); Reg. 1.408-8, Q&A-5(a).

[77] Reg. 1.401(a)(9)-5, Q&A-5(a)(1).

[78] Regs. 1.401(a)(9)-5, Q&A-5(a)(1) and (c)(3).

[79] Reg. 1.401(a)(9)-5, Q&A-5(c)(2).

[80] Reg. 1.401(a)(9)-5, Q&A-5(a)(1).

[81] Reg. 1.401(a)(9)-5, Q&A-5(c)(1).

[82] Reg. 1.401(a)(9)-5, Q&A-5(c)(3).

[83] Reg. 1.402(c)-2, Q&A-12(a).

[84] See Section 72(s)(1)(A).

[85] Section 72(s)(1)(A).

[86] Section 72(s)(2).

[87] 2002-2 CB 710.

[88] Ltr. Rul. 200313016.

[89] Section 72(s)(3).

[90] Section 408(a).

[91] See Section 72(u)(1).

[92] See Sections 72(u)(1) and (3); Rev. Rul. 85-13, 1985-1 CB 184; and Ltr. Rul. 200323012.

[93] See Ltr. Ruls. 9204010, 200449014, and 201124008.

[94] Section 72(u)(1).

[95] See Section 2512(b) and Reg. 1.408-4(a)(2).

[96] See Sections 72(e)(8) and 72(t)(1).

[97] See Schmalzer, TCM 1998-399.

[98] Reg. 1.408-4(a)(2).

[99] See Section 2035(a); see also Reg. 20.2039-1(a) (stating that the fact that an annuity or other payment is not included in the gross estate under Section 2039, "does not mean that it is not includible under some other section ... of Chapter 11").

[100] Section 72(e)(4)(C)(i).

[101]Section 72(e)(4)(C)(ii). A transfer to a former spouse does not require a qualified domestic relations order (which is required to transfer an interest in some qualified retirement plans), because annuities are not subject to the rules of Section 401(a). See Section 401(a)(13)(B). Instead the rules of Section 1041 apply, and the transfer must occur within one year of the marriage ceasing or six years of the marriage ceasing if part of a divorce or separation instrument. See Sections 71(b)(2) and 72(e)(4)(C)(ii), and Temp. Reg. 1.1041-1T(b), Q&A-6 and Q&A-7.

[102]Section 72(e)(4)(C)(iii).

[103]See Section 2035(a).

[104]Ltr. Rul. 201124008.

[105]Although the result was the same, the IRS had previously taken the position that a transfer of an annuity contract by a trust did not fall under Section 72(e)(2)(C), because that section applies to only transfers by an "individual." See Ltr. Rul. 200449014.

[106]See Sections 2039(a) and 2056(a).

[107]See Sections 2056(b)(5) and (b)(6); Rev. Rul. 2006-26, 2006-1 CB 939; and Ltr. Rul. 9423039.

[108]See Reg. 1.401(a)(9)-5, Q&A-7(c)(1).

[109]See Sections 2039(a), 2056(a), and 2056(b)(6).

[110]Section 2056(b)(7)(C).

[111]See Section 72(s)(2).

[112]Sections 72(s)(3) and 1035(a).

[113]See Section 691(a)(1); Rev. Rul. 2005-30, 2005-1 CB 1015; and Rev. Rul. 92-47, 1992-1 CB 198.

[114]Reg. 1.401(a)(9)-4, Q&A-3.

[115]See Reg. 1.401(a)(9)-5, Q&A-7(c)(3), Example 1.

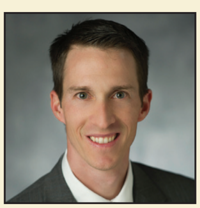
[116]Ltr. Rul. 201021038.

[117]See Kenan, 25 AFTR 607, 114 F2d 217, 40-2 USTC ¶9635 (CA-2, 1940).

[118]See Section 642(c)(1).

[119]Section 408(d)(8).

[120]See Kenan, *supra,* note 117; and Section 642(c)(1).



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Brent Nelson's estate planning and tax practice is focused on family wealth preservation and succession strategies, with particular proficiency in transfer tax and income tax issues. He advises clients on planning for asset protection, foreign spouses, qualified retirement plans, non-qualified annuities, life insurance, charitable giving and individual income tax. In conjunction with lifetime planning, Brent represents clients in trust and estate administration and litigation matters. In addition, he has developed tax strategies for corporate, partnership and limited liability company transactions. Brent also advises clients in audits and disputes with the Internal Revenue Service.

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