

## MAKING RETIREMENT BENEFITS PAYABLE TO TRUSTS

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This seminar handout is an expanded version (it contains more examples and discussion) of Chapter 6, plus selected other sections and forms, from the author’s book *Life and Death Planning for Retirement Benefits*, 7<sup>th</sup> ed. 2011 ([www.ataxplan.com](http://www.ataxplan.com); see Appendix C). Copyright 2013 by Natalie B. Choate. All rights reserved.

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### Abbreviations Used in this Handout

§	Refers to a section of the Code unless otherwise indicated.
¶	Refers to a section of the author's book <i>Life and Death Planning for Retirement Benefits</i> (7 <sup>th</sup> ed., 2011; see Appendix C). If the section number begins with "¶ 6.," it can be found elsewhere in this handout. If the reference does not begin with "¶ 6.," but mentions Appendix A, it can be found in Appendix A of this handout. Otherwise it refers to a section of the book not reproduced here.
ADP	Applicable Distribution Period. ¶ 6.2.00.
BFD	Beneficiary Finalization Date. ¶ 6.2.00.
Code	Internal Revenue Code of 1986 as amended through March 2013.
DNI	Distributable net income. ¶ 6.5.02.
IRA	Individual Retirement Account. § 408.
IRD	Income in respect of a decedent. See ¶ 4.6.01, Appendix A.
IRS	Internal Revenue Service.
IRT	Individual retirement trust (trusteed IRA). ¶ 6.1.07.
MRD	Minimum Required Distribution. ¶ 6.2.00.
O/R-2-NLP	Outright to now-living person. ¶ 6.3.06.
PLR	IRS private letter ruling.
QRP	Qualified Retirement Plan. § 401(a).
RBD	Required Beginning Date. ¶ 6.2.00.
Reg.	Treasury Regulation.

## 6.1 Trust as Beneficiary: Preliminaries

This ¶ 6.1 provides, first, a checklist for drafting a trust to be named as beneficiary of a retirement plan. The rest of ¶ 6.1 covers how trust accounting rules apply to retirement benefits payable to a trust as beneficiary; the transfer of retirement benefit accounts into and out of trusts; and the "individual retirement trust" (or "trusteed IRA" or "IRT").

### 6.1.01 *Trust as beneficiary: Drafting checklist*

When the estate plan calls for naming a trust as beneficiary of retirement benefits, use this checklist to review planning and drafting considerations uniquely applicable to such assets:

1. Is there a strong estate planning reason to name a trust as beneficiary, or is there a way to achieve the planning goals without incurring the risks and complications of naming a trust?

In view of the complications and other disadvantages involved in making retirement benefits payable to a trust, the bias is in favor of leaving the benefits outright to the intended beneficiaries unless there is a compelling reason to leave them in trust. The rest of this checklist deals with drafting the trust, once it has been decided to name a trust as beneficiary.

2. If the trust contains special provisions dealing with retirement benefits, be sure you define “retirement benefits.”
3. Draft the dispositive terms so they will operate on the retirement benefits in accordance with the donor’s intent. For example: If the trust’s dispositive terms will distinguish between “income” and “principal” consider how these terms will apply to the retirement plan and to distributions from it. See ¶ 6.1.02. If a beneficiary is given the annual right to withdraw “five percent of the trust principal,” will the withdrawal power apply to the gross value of any retirement benefit that is payable to the trust (with or without a reduction for the built-in income tax “debt”)? Or will it apply only to amounts the trustee has actually withdrawn from the retirement plan?
4. If the trust is intended to qualify for the federal estate tax marital deduction, comply with the requirements described in ¶ 6.1.02(D) below and in ¶ 3.3.02–¶ 3.3.09 [see Appendix A].
5. Determine whether see-through trust status is important (¶ 6.2.01), and, if it is important, make sure the trust complies with IRS’s MRD trust rules. ¶ 6.2–¶ 6.3. “Precatory” language urging the trustee to take steps to achieve the stretch payout is *not* enough; see PLR 2010-21038 (discussed at ¶ 4.5.06 of *Life and Death Planning for Retirement Benefits*). The trust should be drafted so that it qualifies as a see-through trust *without* the necessity of any trust amendments or reformations after the client’s death.
6. If the trust is to be divided into multiple shares or subtrusts for the benefit of different beneficiaries upon the client’s death, see ¶ 6.3.01 regarding whether, if retirement benefits are allocated only to one particular share, beneficiaries of the other shares are disregarded for MRD purposes, and ¶ 6.3.02 regarding how the “separate accounts” rule applies to trusts. If the benefits are to pass to multiple beneficiaries, and separate accounts treatment is important, leave the benefits to the various beneficiaries directly (i.e., do not leave the benefits to a trust to be divided among the multiple beneficiaries) in the beneficiary designation form. See Form 3.5, Appendix B. For the same reason, if leaving benefits to a trust for the participant’s surviving spouse, and the trust is to pass outright to the participant’s issue on the death of the surviving spouse, name the trust as beneficiary only if the participant’s spouse survives the participant; name the issue directly as contingent beneficiaries if the spouse does not survive. See ¶ 6.3.02 and Form 3.4, Appendix B.
7. To avoid the issue of whether funding a pecuniary bequest with the “right to receive IRD” is a taxable transfer (¶ 6.5.08), avoid having retirement benefits pass through a pecuniary funding formula. If benefits must pass to a trust, make them payable to a trust that will not be divided up. If benefits are going to a trust that will be divided, either specify clearly (in both the beneficiary designation form and the trust instrument) which trust share these retirement benefits go to (so that the benefits pass to the chosen share directly, rather than through the funding formula), or use a fractional formula (fulfillment of which does not trigger immediate realization of IRD) rather than a pecuniary formula (which may).

8. Including a spendthrift clause poses no MRD issues, even in a conduit trust. Since the Code itself imposes spendthrift restrictions on retirement plans (see § 401(a)(13)), such clauses are favored by government policy.
9. Consider whether certain classes of income should be directed to certain beneficiaries. For example, in a trust that authorizes the trustee to accumulate retirement plan distributions (§ 6.3.07), the trust could direct the trustee to distribute all “investment income” to the life beneficiary, to avoid having the 3.8 percent “surtax” on investment income (see § 1411, effective for years after 2012) imposed on the trust; this could make sense if it is expected that the trust beneficiary will probably not have a high enough income to incur the surtax. Such an allocation of a specific class of income is respected for income tax purposes if it has independent economic effect. Reg. § 1.643(a)-5(b), § 1.642(c)-3(b).
10. If the trust has charitable and noncharitable beneficiaries, either direct the retirement benefits to be used to fund the charitable gifts (if the goal is to have the benefits pass income tax-free to the charities) or forbid such use (if the goal is to achieve a stretch payout for the trust’s individual beneficiaries).

#### *6.1.02 Trust accounting for retirement benefits*

Suppose a trust is the beneficiary of a deceased client’s \$1 million IRA. The trust provides that the trustee is to pay all income of the trust to the client’s surviving spouse for life, and at the spouse’s death the trustee is to distribute the principal of the trust to the client’s children. The trust receives a \$50,000 minimum required distribution (MRD; see Chapter 1) from the IRA. Is that distribution “income” that the trustee is required to pay to the spouse? Or is it “principal” that the trustee must hold for future distribution to the client’s children? Or some of each?

- A. Trust accounting income vs. federal gross income.** A retirement plan distribution generally will constitute gross income to the trust for federal income tax purposes (§ 6.5.01), but that same distribution may be “principal” (or “corpus,” to use the IRS’s preferred term) for trust accounting purposes:

**Jorge Example:** Jorge dies leaving his \$1 million 401(k) plan to a trust for his son. The trustee is to pay the trust “income” to the son annually, and distribute the “principal” to the son when he reaches age 35. The 401(k) plan distributes a \$1 million lump sum to the trustee a few days after Jorge’s death. This is not a “required” distribution; the trustee simply requested the distribution from the plan. Barring an unusual provision in the trust instrument or applicable state law, the entire \$1 million plan distribution is considered the trust “corpus.” On the federal income tax return for the trust’s first year, the trust must report the \$1 million distribution as gross income, because it is “income” for income tax purposes even though it is “principal” for trust accounting purposes. The trustee invests the money that’s left after paying the income tax on the distribution, and pays the income (interest and dividends) from the investments each year to Jorge’s son.

- B. Trust accounting income vs. MRD.** See ¶ 6.2–¶ 6.3 regarding the “minimum distribution rules.” MRDs and trust accounting income are totally different and unrelated concepts.
- C. State law; the 10 percent rule of UPIA 1997.** If the “trust accounting income” attributable to a retirement plan held by the trust is not the same as federal gross income, and is not the same as the MRD, what is it? Unless the trust has its own definition (which is the preferred solution; see ¶ 6.1.03(B)), the answer is determined by state law.

For example, the 1997 Uniform Principal and Income Act (“UPIA”), which was adopted by a majority of states, provides trust accounting rules for retirement plan distributions. UPIA § 409 governs the trust accounting treatment of (among other things) any “payment” from an IRA or pension plan.

UPIA § 409(b) provides, first, that, to the extent a payment from a retirement plan “is characterized as interest or a dividend or a payment made in lieu of interest or a dividend, a trustee shall allocate it to income.” The balance of any payment that is partly so characterized is allocated to principal. The official Comment to § 409(b) indicates that the drafters envisioned § 409(b) as applying to a very narrow set of circumstances, namely, an employee benefit plan “whose terms characterize payments made under the plan as dividends, interest, or payments in lieu of dividends or interest.” For example, under an employee stock ownership plan, the employee’s plan account owns shares of company stock; when the stock pays a dividend, it is immediately distributed out of the plan to the employee (or, if he is deceased, to the beneficiary, in this case the trust). See Code § 404(k). The Comment continues: “[UPIA] Section 409(b) *does not apply to an IRA* or an arrangement with payment provisions similar to an IRA. IRAs and similar arrangements are subject to the provisions in [UPIA] Section 409(c).” Emphasis added.

UPIA § 409(c), which governs IRA and most other retirement plan distributions, provides: If “all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal.” This is known as “the **10 percent rule**.” A nonrequired payment is allocated entirely to principal.

Unfortunately, the 10 percent rule will provide too little income in most cases, especially if the benefits are being paid out over a long life expectancy. For example, if the trust’s Applicable Distribution Period (ADP; ¶ 6.2.00) is the 40-year life expectancy of the oldest trust beneficiary (¶ 6.2.01), the first year’s MRD will be  $[\text{account balance}] \div [40]$ , i.e., only 2.5 percent of the value of the retirement benefits. That is already a low percentage, and the “income” portion of the distribution under UPIA § 409(c) would be only 10 percent of that. It seems unlikely that a trust donor would choose this method of determining the amount of “income” distributed to the life beneficiary.

- D. Income for a marital deduction trust.** Trust accounting sometimes matters for tax purposes; most importantly for estate planners, the definition of “income” matters for purposes of the federal estate tax marital deduction. Two other situations in which the IRS “cares” about what is treated as income or principal for trust accounting purposes are:

- ◆ In the case of a qualified domestic trust (QDOT) for the benefit of a noncitizen spouse, distributions of “corpus” from a QDOT are subject to the deferred estate tax, while “income” distributions are not. See § 2056A(b)(3)(A), (B), and the author’s *Special Report: Retirement Benefits and the Marital Deduction (Including Planning for the Noncitizen Spouse)*, downloadable at [www.ataxplan.com](http://www.ataxplan.com); and
- ◆ In the determination of whether a trust is required to distribute all income currently so that it is taxed as a simple trust under § 651 rather than as a complex trust under § 661. Reg. § 1.651(a)-1.

Generally, the surviving spouse must be entitled for life to all income of a trust in order for such trust to qualify for the federal estate tax marital deduction. § 2056(b)(7). This subsection “D” discusses what the “income” is that the spouse must be “entitled to” with respect to *retirement benefits* left to a trust, in order for such trust to qualify for the federal estate tax marital deduction. See ¶ 3.3.02–¶ 3.3.07 (Appendix A) for how to meet the “entitled” (and other) requirements to obtain the marital deduction for retirement benefits left to a trust.

A definition of “income” provided by the governing instrument or by applicable state law will be accepted for tax purposes if it “provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year....” See § 643(b) and Regs. § 1.643(b)-1, § 20.2056(b)-5(f)(1). The IRS found that the UPIA 1997’s 10 percent rule (see “C” above) of determining income “*does not satisfy the marital deduction income requirements of § 20.2056(b)-5(f)(1) and § 1.643(b)-1, because the amount of the...[MRD] is not based on the total return of the IRA (and therefore the amount allocated to income does not reflect a reasonable apportionment of the total return between the income and remainder beneficiaries).*” Rev. Rul. 2006-26, 2006-22 I.R.B. 939; emphasis added.

The IRS then explained what it views as the “income” of a retirement plan that the surviving spouse must be entitled to when such plan is payable to a marital deduction trust: either the plan’s internal investment income (“trust-within-a-trust” concept; see ¶ 6.1.03(C)) or an acceptable (i.e., 3%–5%) annual “unitrust” percentage amount (see ¶ 6.1.04).

Because of problems with the 10 percent rule, the American College of Trust & Estate Counsel (ACTEC), through its Employee Benefits Committee, and other interested groups are seeking to have the UPIA amended to eliminate it. A number of states have modified § 409 so that retirement plan distributions received by the trust are accounted for using a unitrust or trust-within-a-trust approach rather than the 10 percent rule. Unfortunately, most states’ approaches still do not satisfy the IRS’s definition, because their rules account only for *distributions* the trustee receives from the retirement plan, not for the investment results “inside” the retirement plan. Some other states have not adopted the 1997 UPIA at all. Every drafter and trustee must check the applicable state law regarding its definition of “income” with respect to retirement benefits payable to the trust.

### 6.1.03 *Trust accounting: Drafting solutions*

There are three ways to avoid the problems discussed in ¶ 6.1.02: draft a totally discretionary trust (see “A” below); define income as it applies to retirement plan benefits (see “B” and “C”); or use the “unitrust” approach (see ¶ 6.1.04). For a marital deduction trust, use “C” or the “unitrust” approach; do not use “A.”

This ¶ 6.1.03 gives an overview of this subject; it does not provide sufficient detail to enable the drafter to prepare a trust instrument without studying the applicable state law and IRS standards set forth in regulations under § 643 and in Rev. Rul. 2006-26. Also, this discussion deals with planning approaches; the trustee of a trust that is *already operative* needs to comply with the terms of the instrument and applicable state law to determine the trust’s income, and does not have the option to simply adopt whatever method is appealing.

- A. Draft so the definition of “income” doesn’t matter.** The trust accounting question may be unimportant in a totally discretionary trust. For example, if the trust provides that the trustee shall pay to the life beneficiary “such amounts of the income and/or principal of the trust as the trustee deems advisable in its discretion from time to time,” it will make no difference whether the internal income of (or a distribution from) a particular retirement plan is treated as income or principal for trust accounting purposes. The beneficiaries’ substantive rights do not depend on whether a particular asset or receipt is classified as income or principal.

However, if the trustee’s compensation is based on differing percentages of trust income and principal, even a totally discretionary trust will have to resolve the income/principal question regarding the retirement benefits. Also, this approach generally cannot be used for a marital deduction trust (¶ 6.1.02(D)).

- B. Draft your own definition of income.** Another way to deal with the trust accounting problem is to provide, in the trust instrument, how retirement benefits are to be accounted for. This solution is recommended because even if the applicable state law definition at the time the trust is drafted suits the client’s needs, the state law could change.

What should such a trust accounting provision say? First determine what the client is trying to accomplish. If the client wants his beneficiary to receive the “income” of the trust, find out what the client thinks that means with respect to the retirement benefits. The client may want the beneficiary to receive the entire MRD. Most likely the client will have no idea what he wants until explain the alternatives. Second, see ¶ 6.1.02(D) if the trust must comply with the IRS’s definition of income.

- C. “Trust within a trust” approach.** One approach, which works for IRAs and other “transparent” defined contribution plans where the trustee controls the plan’s investments, and can readily determine exactly how much income those investments earn and when, is to treat the retirement plan as a “trust-within-a-trust”: Investment income earned inside the plan

is treated as trust income just as if it had been earned in the trust's taxable account. The IRS has approved this approach for marital deduction trusts. ¶ 6.1.02(D).

**Debra Example:** Debra's trust provides that after her death the trustee shall pay all "income" of the trust (including income of any retirement plan payable to the trust as beneficiary) to Debra's son Winston annually. The trust is the beneficiary of Debra's IRA, and also holds stocks and bonds in a taxable account. In Year X, the trust earns \$4,000 of interest and dividends in the taxable account, and the IRA receives \$3,000 of interest and dividends from its investments. The trustee withdraws from the IRA \$3,000 (or the MRD for Year X, whichever is greater; see ¶ 6.2.00), and distributes \$7,000 to Winston.

The trust-within-a-trust approach will not work for a defined benefit plan (¶ 8.3.04), or any other plan where the trustee cannot readily get the information needed to compute the plan's internal income. Thus, there must be some type of default rule to cover these plans. A unitrust approach is recommended for the default rule, if permitted by applicable state law; see ¶ 6.1.04.

#### *6.1.04 "Total return" or "unitrust" method*

A trend in trust drafting is to eschew "income" and "principal" concepts in favor of a "total return" (also called "unitrust") approach: The life beneficiary receives a fixed percentage (unitrust percentage) of the value of the trust's assets each year, rather than receiving the traditional trust accounting income of rents, interest, and dividends. The UPIA 1997 (¶ 6.1.02(C)) permits the unitrust method of trust accounting.

The IRS will accept a definition of income based on the unitrust method if that method is permitted by state law *and* the annual fixed percentage to which the income beneficiary is entitled is not less than three nor more than five percent of the trust's value (with "value" either being determined annually or being averaged on a multiple year basis). Reg. § 1.643(b)-1.

Retirement benefits pose a valuation problem for the unitrust approach: Should the built-in income tax liability be deducted from the nominal value of the benefits? That issue can be avoided by distributing, each year, the required percentage of the retirement plan assets and the required percentage of the nonretirement assets. This method of implementing the unitrust approach was blessed, for a marital deduction trust, in Rev. Rul. 2006-26 (¶ 6.1.02(D)).

#### *6.1.05 Transferring a retirement plan out of a trust or estate*

When a trust terminates, the trustee can transfer, intact, to the residuary beneficiaries of the trust, any IRA or other retirement plan then held by the trust. The same applies to the participant's estate (if the benefits pass to the estate as either named or default beneficiary), and to the estate of a beneficiary who dies prior to withdrawing all the benefits from an inherited retirement plan: The estate can transfer the IRA or plan to the estate's beneficiaries. This ¶ 6.1.05 explains the legal basis under which such transfers are permitted. See ¶ 6.5.07–¶ 6.5.08 for the federal income tax effects of such a transfer.

- A. Transferability of retirement benefits.** An IRA is transferable. The owner of an IRA (whether such owner is the participant or the beneficiary of the account) can transfer the ownership of the account to another person or entity. Nothing in § 408 (the statute that creates IRAs) prohibits transferring an IRA; on the contrary, the Code recognizes that IRAs can be assigned, since it discusses transfer of an IRA in connection with divorce (§ 408(d)(6)) and pledging the account as security for a loan (§ 408(e)(4)). The Treasury’s Chief Counsel confirmed in CCA 2006-44020 that an IRA is transferable. The question is not whether the account can be transferred; the question is whether such transfer will terminate the account’s status as an IRA, causing an immediate deemed distribution.

With respect to nonIRA plans, such as QRPs, the plan account generally “may not be assigned or alienated” (§ 401(a)(13)(A)); this is called ERISA’s “anti-alienation rule”). The anti-alienation rule is intended to prevent assignment (voluntary or involuntary) of the benefits to creditors of the participant or beneficiary, or any attempt to borrow against or sell the benefits. The rule has no bearing on the disposition of the benefits at the death of the participant (when the benefits are “assigned” to the beneficiary), or at the subsequent death of the beneficiary (which, again, causes the benefits to be “transferred” to someone else) or upon the termination of the existence of the beneficiary (in the case of an estate or trust which is closing). Transfers of benefits out of a trust or estate to the trust or estate beneficiary(ies) are transfers *to* the participant’s beneficiary, not transfers *away* from the beneficiary.

Numerous PLRs have recognized these principles; the PLRs take it for granted that the benefits can be transferred out of an estate or trust, and address only the income tax consequences of such transfers. See “C” below. For an opposing viewpoint, see “D” below.

A trust can make such a transfer to its beneficiaries regardless of whether the trust qualifies as a “see-through trust” under the minimum distribution rules (§ 6.2); an estate can make such a transfer even though an estate can NEVER qualify as a “Designated Beneficiary” (§ 6.2.00).

The transfer of an inherited retirement plan or IRA from a trust or estate to the beneficiary(ies) of the trust or estate has *no effect* on the Applicable Distribution Period for the benefits. Such a transfer is *solely* for the purpose of allowing the trust or estate to terminate or otherwise cease to have control of the benefits. Furthermore, there is not much point in doing this type of transfer (and the plan probably won’t allow it anyway) if the plan is a qualified plan and is payable to the estate, because the plan will normally pay benefits only in the form of a lump sum. The transfer procedure is most useful for IRAs, not other types of plans. Do NOT confuse these transfers with the nonspouse beneficiary rollover to an inherited IRA (see § 4.2.04 of *Life and Death Planning for Retirement Benefits*).

See Form 5.4, Appendix B, for how to request such a transfer.

- B. Examples of fiduciary transfers of inherited retirement plans.** Here are some common examples of situations in which such transfers are called for:

**Foster Example: Division into marital and family trusts.** Foster dies, leaving his IRA to the Foster Revocable Trust as beneficiary. The Foster Revocable Trust provides that, upon Foster’s death, the trustee is to divide all assets of the trust into two separate trusts, the Marital Trust and the

Family Trust, pursuant to a fractional formula. All retirement benefits are to be allocated to the Marital Trust. The trustee instructs the IRA provider to change the name of the owner of the inherited IRA from “Foster Revocable Trust, as beneficiary of Foster, deceased,” to “Marital Trust, as beneficiary of Foster, deceased.” The trustee has transferred the IRA from the Foster Revocable Trust to the Marital Trust.

**Stan Example: Trust termination upon spouse’s death.** Stan names his testamentary trust as beneficiary of his IRA. The trust provides that, after Stan’s death, the trustee is to pay income of the trust to Mrs. Stan for life. On her death, the trust is to terminate, with the principal of the trust passing to Stan’s son Yishai. The trustee takes annual MRDs from Stan’s IRA computed using the life expectancy of Mrs. Stan, which is 18 years, as the ADP (§ 6.2.00). Mrs. Stan dies 12 years later. It is now time for the trust to terminate. There are still six years left in the ADP. The trustee instructs the IRA provider to change the titling of the inherited IRA from “Stan Testamentary Trust, as beneficiary of Stan, deceased,” to “Yishai, as successor beneficiary of Stan, deceased.” The trustee has transferred the IRA from the testamentary trust to the trust’s remainder beneficiary.

**Noah Example: Division among multiple children.** Noah dies, leaving his IRA to the Noah Family Trust as named beneficiary. The trust provides that, upon Noah’s death, the trust is to be divided into three equal shares, one for each of Noah’s sons Shem, Ham, and Japheth. Shem and Ham are to receive their shares outright; Japheth’s share is to be held in trust for him for life, with remainder outright at Japheth’s death to Japheth’s issue, if any, otherwise to Shem and Ham outright. Upon learning of Noah’s death, the IRA provider titled the IRA “Noah Family Trust, as beneficiary of Noah,” and the trust’s taxpayer identification number was attached to the account. The trustee now instructs the IRA provider to divide the IRA into three equal accounts, and to change the titling of two of those accounts. One account is to be retitled “Shem, as beneficiary of Noah,” and the other “Ham, as beneficiary of Noah.” The trustee has transferred two thirds of the IRA from the trust to these two sons. The Social Security numbers of Shem and Ham will be associated with those two inherited IRAs. The third inherited IRA created out of Noah’s IRA stays in the trust (to be held for the life benefit of Japheth), so its titling (and associated taxpayer identification number) does not change for now.

**C. PLRs approving these transfers.** Many private letter rulings have approved the transfer of inherited IRAs and other plans from the trust named as beneficiary of the plan to the individual trust beneficiaries. PLR 2001-31033 (Rulings 5, 6, and 7) is typical. This ruling allowed the transfer of “IRA Y” from a terminating trust to the participant’s children, C and D. From the ruling: “The provision of Trust X which provides for its termination does not change either the identity of the individuals who will receive the IRA Y proceeds or the identity of the designated beneficiary of IRA Y.... Furthermore, the Trust X termination language which results in distributions from IRA Y being made directly to Taxpayers C and D instead of initially to Trust X and then to Taxpayers C and D was language in Trust X approved by [the participant] during his lifetime which reflects [the participant’s] intent to pay his children directly instead of through Trust X.”

Other rulings approving the transfer of a retirement plan from a trust to the trust beneficiaries (without requiring termination of the plan account or otherwise triggering immediate income tax) are: regarding IRAs, PLRs 2000-13041, 2001-09051; 2003-29048 (IRA payable to a trust divided into four “sub-IRAs,” each to be held by one of the individual trust beneficiaries); 2004-33019; 2004-49040–2004-49042; 2005-26010; 2006-15032; 2006-18023 (involving a nonqualified annuity); 2007-40018; 2007-50019; 2008-03002 (annuity contract); 2008-26028; 2009-35045; and 2010-38019. Regarding transfer of an inherited IRA to *charitable* residuary beneficiaries, see 2006-52028.

For rulings permitting Beneficiary IRAs to be opened directly in the name of the individual trust beneficiaries (rather than first in the name of the trust), where the IRA was payable to a trust that was to terminate immediately upon the participant’s death and be distributed outright to the individual beneficiaries, see PLRs 2005-38030, -38031, -38033, and -38034.

PLRs 2002-34019 and 2008-50058 permitted retirement benefits to be transferred, intact, out of an estate to the estate beneficiaries. In PLR 2010-13033, an IRA was payable to an estate; the IRS permitted transfer of the IRA from the estate to the “pourover” trust that was beneficiary of the estate, and thence to the trust’s beneficiaries. For more PLRs, see ¶ 6.5.07(B). Some recent rulings:

In PLR 2011-28036, the participant died after his required beginning date leaving his IRA to his estate. The executor of the estate sought to transfer the inherited IRA into two equal inherited IRAs in the names of the two estate beneficiaries, in order to close the estate. The IRS granted the ruling, and ruled that the ADP for the inherited IRAs would continue to be the life expectancy of the deceased participant (see ¶ 1.5.08 of *Life and Death Planning for Retirement Benefits*).

In PLR 2012-10047, “Decedent A” left his IRA to “Trust T.” After payment of debts etc., Trust T was to terminate upon A’s death and be distributed outright to his two sons, B and C. The IRS ruled that Trust T qualified as a see-through trust; and that “division of IRA X by means of trustee-to-trustee transfers into two inherited IRAs in the name of Decedent A (a) will not result in taxable distributions or payments under Code section 408(d)(a), and (b) will not constitute a transfer causing inclusion in the gross income of Trust T or either beneficiary under Code section 691(a)(2).” This was an unusually clear and thorough ruling; not all the rulings specifically mention § 691.

PLR 2012-10045 is similar (IRA left to Trust T; Trust T was to terminate at participant’s death and be distributed outright equally to his spouse and two children; IRS ruled the IRA could be divided into separate inherited IRAs and transferred to the respective beneficiaries, with the spouse being allowed to have her share transferred directly to an IRA in her own name and the other beneficiaries receiving “inherited IRAs), but is also a bit disturbing. The IRS ruled that the two children as beneficiaries would have to take MRDs calculated based on the life expectancy of the spouse because she was the oldest trust beneficiary. While that is correct as far as it goes, it is not clear why the family did not get a ruling that the complete distribution of the spouse’s share to her prior to the beneficiary finalization date (BFD) (September 30 of the year after the year of the participant’s death) “eliminated” her as a beneficiary, so that the two children could use the older child’s life expectancy rather than being stuck with the spouse’s life expectancy as their ADP. See Reg. § 1.401(a)(9)-4, A-4(a), PLRs 2004-49041–2004-49042, and ¶ 1.8.03(B) and ¶ 6.3.03. That topic was not mentioned in the ruling. Since the surviving spouse was allowed to “roll over” her one-third share of the decedent’s IRA into her own IRA, she ceased to be a beneficiary of the decedent’s IRA and thus should have not counted as a beneficiary. Possibly the parties did not get her

distribution/rollover completed by the BFD and that is why she still counted as a beneficiary of the trust for purposes of determining the ADP.

Unfortunately, PLRs cannot be cited as authority. ¶ 6.4.02. The above PLRs cite Rev. Rul. 78-406, 1978-2 C.B. 157, which established the rule that an IRA-to-IRA transfer is not a “distribution” and accordingly does not have to meet the requirements applicable to a “rollover.” However, Rev. Rul. 78-406 did not deal with transferring an *inherited* IRA, let alone transferring it from a terminating trust (or estate) to the trust (or estate) beneficiaries. It referred to the transfer from one IRA to another IRA in the same name (the participant’s), which is not quite the same as a transfer from an IRA in the name of a trust as beneficiary to an IRA in the name of an individual or charity as successor beneficiary.

**D. IRA providers and plan administrators.** Some *IRA providers* (see [www.ataxplan.com/bulletin\\_board/ira\\_providers.htm](http://www.ataxplan.com/bulletin_board/ira_providers.htm)) readily permit these transfers, upon receipt of proper instructions from the fiduciary plus (in some cases) an opinion of counsel. However, some IRA providers do not allow these transfers.

A fiduciary faced with an IRA provider’s refusal to allow transfer of an inherited IRA to the trust or estate beneficiaries has four choices: #1. Cash out the plan and give up further deferral. #2. Keep the trust or estate open until the end of the ADP, to preserve continued deferral of distributions, but at the cost of ongoing administration expenses. #3. Get an IRS ruling, if that will convince the IRA provider to allow the transfer. #4. Move the account (still in the name of the estate or trust), by means of an IRA-to-IRA transfer (see ¶ 2.6.01(E) and ¶ 2.6.08 of *Life and Death Planning for Retirement Benefits*) to a more cooperative financial institution, and *then* transfer it to the beneficiaries. Since options #1–#3 involve substantially increased taxes or costs, #4 is encouraged.

#### ***6.1.06 Can a participant transfer an IRA to a living trust?***

A participant’s transfer of an IRA to a trust that is entirely a grantor trust as to him (¶ 6.3.10) should not be treated as an “assignment” of the account, since an individual and his grantor trust are deemed to be in effect “the same person” under Rev. Rul. 85-13, 1985-1 C.B. 184, *provided* that no person other than the participant can receive any distributions from the trust during the participant’s life, and that the grantor retains the right to remove the IRA from the trust. The trust into which the IRA is transferred would be named as owner and beneficiary of the IRA.

If the trust permits distributions to anyone other than the participant during the participant’s life, the transfer might (despite Rev. Rul. 85-13) be considered a transfer of the benefits to another person, which would terminate the account’s status as an IRA. See § 72(e)(4)(A)(ii); Reg. § 1.408-4(a)(2); and *Coppola v. Beeson*, 2005-2 USTC ¶50,503, 96 AFTR 2d 2005-5375 (5<sup>th</sup> Cir. 2005) (participant’s pledge of his 403(b) account, as security for alimony he owed, treated as a distribution). Thus, the typical living trust provision that allows distributions to be made during the grantor’s lifetime for the benefit of the grantor’s dependents may not be suitable for a trust that is to hold the grantor’s retirement benefits prior to his death.

It would not be advisable to transfer an IRA to a grantor trust without first obtaining an IRS ruling blessing the transfer. To date the only IRS pronouncements touching on the subject of

transferring an IRA to a grantor trust are five private letter rulings. There are three favorable rulings dealing with a beneficiary's transfer of an *inherited* IRA (see PLRs 2006-20025, 2008-26008, and 2011-16005, discussed at ¶ 4.6.03(C) of *Life and Death Planning for Retirement Benefits*).

But see PLR 2011-29045, in which "Taxpayer A" attempted to transfer her IRAs into "an IRA within a grantor trust benefitting Taxpayer A." The attempted transfer failed because, says the IRS, the recipient financial institution "correctly determined that a grantor trust could not be the owner of an IRA." But then again: PLR 2012-45004 dealt mainly with the ability of the surviving spouse to disclaim a decedent's retirement benefits, but the ruling starts off with the intriguing statement that the participant, prior to his death, had "established a retirement plan trust" to benefit himself during his life, and this trust "held an Individual Retirement Account (IRA). Prior to his death, the required minimum distributions (RMDs) from the IRA were automatically deposited into a bank account held by" the trust. Thus, in PLR 2012-45004, unlike in PLR 2011-29045, the IRS seemed to think it was just fine and dandy that the participant's IRA was held in a trust during his life. So the area is unsettled. Get a ruling.

#### 6.1.07 *Individual retirement trusts (trusteed IRAs)*

Individual retirement arrangements can be established in either of two legal forms, a custodial account (§ 408(h)) or a trust (§ 408(a)); both are treated identically for all tax purposes. Most IRAs are established as custodial accounts rather than as trusts. This Chapter deals with naming a trust as beneficiary of an IRA or other retirement plan; however, it should be noted that in some cases an IRA owner can use a "**trusteed IRA**" (also called an "**individual retirement trust**," or "**IRT**") in place of a standard custodial IRA (or Roth IRA) payable to a separate trust as beneficiary.

An IRT can combine the *substantive terms* of a trust and the *tax characteristics* of an IRA. The client (IRA owner) puts the trust terms and conditions into the IRT document. The document must comply with the minimum distribution rules and all other requirements of § 408, but otherwise there's no limit on what it may provide, other than what the IRT provider is willing to accept.

**Troy Example:** Troy has a \$1 million trusteed IRA with XYZ Trust Co. XYZ manages the investments and pays the annual MRD to Troy, along with such additional distributions as Troy may request from time to time. Upon Troy's death, XYZ, as Trustee and IRA provider, continues to hold the account for the benefit of Troy's wife Joy. As provided in the IRA-trust document, XYZ pays to Joy, annually, the greater of the MRD or the income earned by the IRA, and such additional amounts as XYZ, as trustee, deems advisable for her health and support. After Joy's death, XYZ pays annually to Troy's children, in equal shares, the MRD. As each child reaches age 40, he gains the right to withdraw additional amounts from his share of the trusteed IRA.

Here are some reasons why a client might consider using an IRT instead of the more common custodial IRA:

- ✓ **Participant's disability.** The IRT agreement can authorize the trustee to use the IRT assets for the participant's benefit during disability. An IRA custodian will not perform those

duties; custodial IRA assets can be used for the benefit of the disabled participant only through the mechanism of a durable power of attorney or guardianship.

- ✓ **Limit beneficiary's access.** An IRA beneficiary can generally withdraw the entire account at will. An IRT can limit the beneficiary's withdrawal rights so that the beneficiary can withdraw only the MRDs; or MRDs plus additional payments (such as for health or support). Thus, it may be used in place of a conduit trust in some cases. See ¶ 6.3.05, ¶ 6.4.05(A).
- ✓ **Limit beneficiary's control at beneficiary's death.** Under an IRT, but not under most custodial IRAs, the *participant* can specify the "successor beneficiary," i.e., the person or entity who will become the owner of the account after the original beneficiary's death. See ¶ 1.5.12(E) of *Life and Death Planning for Retirement Benefits*.
- ✓ **Avoid complications of MRD trust rules.** A trust named as beneficiary of a custodial IRA must meet complicated IRS requirements to qualify as a "see-through trust" (¶ 6.2–¶ 6.3). An IRT does not have to jump through these hoops, because the trust is not the beneficiary of an IRA—it *is* the IRA.

There are two types of trustee IRAs, custom-drafted and (for lack of a better word) "pre-approved prototype." The "prototype" form of IRT is a complete trust agreement for which the IRA provider has obtained IRS approval. It comes as a pre-printed booklet (similar to the documents establishing "custodial" IRAs, but longer), which functions as an adoption agreement. The IRA participant is given "check the box" choices for various popular trust provisions, such as: the beneficiary can withdraw only the MRD (or, for a spouse-beneficiary, the greater of the account's income or the MRD); or MRDs plus more if needed for health or support, or in the trustee's discretion; with or without the right to greater control upon reaching a certain age. If the participant's estate planning goal is met by one of these "canned" options, the participant can avoid paying a legal fee to draft a trust agreement by using a trustee IRA.

More customizable trustee IRAs also exist. *Any* bank can serve as trustee of a trustee IRA; no special IRS approval is required. The bank needs to be familiar with the requirements applicable to IRA providers. Then, all that is required is for the participant and IRA provider to enter into a trust agreement that complies with § 408. The parties can use IRS Form 5305, "Traditional Individual Retirement Trust Account" (or 5305-R for a trustee Roth IRA), adding any extra provisions appropriate for the client's estate plan as an attachment (part of "Article VIII" of Form 5305, "additional provisions"). The estate planning lawyer should have a leading role in preparing this document. IRS approval is not required and in fact cannot be obtained for an individual's IRA or IRT.

An IRT has some drawbacks: The provider's fee (or minimum account size) is typically higher than for a custodial IRA because more services are provided, but that may be appropriate if the client needs the services. Also, since the IRT must pass all MRDs out to the IRT beneficiary directly, the IRT is not suitable for a client who wants MRDs accumulated and held in the trust for future distribution to the same or another beneficiary.

### 6.1.08 *Prohibited transaction issues*

Engaging in a prohibited transaction (PT) with respect to an IRA can disqualify the IRA. § 408(e)(2). In Advisory Opinion 2009-02A, Seymour’s IRA was to be made payable to a trust of which his son Jason would be the trustee, and his grandson Cole (son of trustee Jason) would be the beneficiary. The Department of Labor (DOL) ruled that Jason was a “fiduciary” with respect to the IRA and that therefore both he and his son Cole were “disqualified persons” (DQPs). However, the DOL ruled that distributions from the IRA to the trust were *not* PTs as long as such distributions were consistent with the terms of the Code and of the trust instrument, even though the distributions would have an effect (under applicable state law) on the size of the trustee’s commissions. Such distributions would not be considered the type of fiduciary self-dealing with IRA assets prohibited by § 4975(c)(1)(D), (E). If the trustee were to withdraw from the IRA more than the required distribution, for the purpose of fattening his commissions, that sort of breach of fiduciary duty would be a matter of state law, not a PT.

## 6.2 The Minimum Distribution Trust Rules

Once a retirement plan or IRA owner (the “participant”) dies, the retirement plan or IRA must make certain annual minimum required distributions (MRDs) to the beneficiary(ies) of the account. The most desirable form of post-death payout, generally, is annual instalments over the life expectancy of the beneficiary, because this allows the longest tax deferral (or tax-free accumulation, in the case of a Roth plan). This sought-after “stretch” or “life expectancy” payout is available only for benefits payable to a “Designated Beneficiary,” which generally means an individual. However, IRS regulations allow a trust to qualify for this favorable form of payout if various requirements, explained in this ¶ 6.2 and in ¶ 6.3, are met.

### 6.2.00 *The minimum distribution rules: Executive summary*

Retirement benefits are generally subject to the “minimum distribution rules” of § 401(a)(9) of the Code, also called the “minimum required distribution” (MRD) rules. Understanding these rules is essential to estate planning for retirement benefits for both *planning* and *compliance* reasons. First, since the general rule is that retirement plan benefits are not subject to income tax until distributed to the client or beneficiary, and since the longer such taxes are deferred the longer the client is investing “Uncle Sam’s money” for the personal benefit of the client and his family, many clients desire to defer the distributions as long as possible. Thus the planner needs to know how to obtain the longest deferral under the various choices offered by the minimum distribution rules. Second, the advisor needs to be able to advise the client on how to comply with the rules to avoid penalties.

This mini-summary gives a basic overview of the minimum distribution rules. This overview does not provide sufficient detail to enable the reader to compute required distributions; it is intended merely to show the lay of the land. For full detail on these rules, see Chapter 1 of *Life and Death Planning for Retirement Benefits*.

Congress does not allow the income tax deferral of retirement benefits to last forever. The “minimum distribution rules” of § 401(a)(9) dictate when participants and beneficiaries must start withdrawing benefits from retirement plans, and, once MRDs begin, how much must be withdrawn each year. (However, no MRD was required for the year 2009; see ¶ 1.1.04 of *Life and Death Planning for Retirement Benefits*.)

The Code sections are meaningless in themselves; the “real” minimum distribution rules are contained in Treasury regulations § 1.401(a)(9)-1—§ 1.401(a)(9)-9.

There are two sets of MRD rules, one applicable to the original owner of the retirement plan (the “participant”), called the lifetime distribution rules, the other applicable to beneficiaries who inherit a plan (the post-death rules).

Both lifetime and post-death MRDs are calculated in the same basic manner: in each “distribution year” (year for which a distribution is required) you divide the prior year-end account balance by a life expectancy factor (called the “divisor” or “**Applicable Distribution Period**” (ADP)) obtained from an IRS table. The MRD so determined must be withdrawn by the end of the distribution year. Failure to withdraw the required amount results in a 50 percent penalty. § 4975.

The MRD is indeed just a minimum; the participant or beneficiary is always free to withdraw more than the MRD. Withdrawing more than the minimum does not give the recipient a “credit” that can be used to reduce MRDs in later years; each year stands on its own. Retirement plans are not required to allow participants or beneficiaries to withdraw benefits gradually using the MRD method. Many 401(k) plans (for example) offer only the lump sum distribution form of benefit.

There is at least one exception to each of the above rules!

The first “distribution year” for lifetime MRDs from an IRA is the year the participant reaches age 70½. For that year only, the MRD can be postponed until the participant’s “required beginning date” (RBD), which is April 1 of the following year. This is an exception to the normal rule that MRDs must always be withdrawn by the end of the distribution year. The RBD may be later for other types of retirement plans if the participant is still working.

The participant obtains his divisor or ADP for each distribution year from the IRS’s Uniform Lifetime Table (see Appendix A of *Life and Death Planning for Retirement Benefits*, or *IRS Publication 590*), based on the age he will attain on his birthday in that year. The ULT factors represent the joint and survivor life expectancy of the participant and a hypothetical individual who is 10 years younger than the participant. Thus, the ULT is designed to liquidate the plan balance gradually over the joint life expectancy of the participant and this hypothetical younger individual. The effect is to guarantee that the participant will not withdraw all of his plan balance prior to death, if he withdraws only the MRD.

The participant can use an even more favorable table, the Joint and Survivor Life Expectancy Table, if the sole beneficiary of the plan is the participant’s spouse who is more than 10 years younger than the participant.

On the participant’s death, the beneficiary must take the MRD for the year of the participant’s death (if any), to the extent the participant didn’t take it himself. If the participant left his benefits to an individual beneficiary, or to a qualifying “see-through trust” (see the rest of this ¶ 6.2) then the participant is said to have left his benefits to a “**designated beneficiary**.” In the year *after* the year of the participant’s death, the designated beneficiary must start taking annual MRDs based on the life expectancy of the designated beneficiary (or of the oldest beneficiary of the see-through trust,

as the case may be). The beneficiary obtains his divisor or ADP from the IRS's Single Life Expectancy Table (see Appendix A of *Life and Death Planning for Retirement Benefits*, or *IRS Publication 590*), based on the beneficiary's birthday in the year after the year of the participant's death. In later years, the beneficiary's divisor is the prior year's divisor minus one.

This method of calculating post-death MRDs to a beneficiary is sometimes called the "life expectancy" or "stretch" payout method. The effect is, if the beneficiary takes only the MRD each year, to gradually liquidate the plan over the beneficiary's life expectancy. With a younger beneficiary, the MRDs in the early years will normally be less than the plan's internal investment return, so both the plan balance and the annual MRDs will increase gradually until the beneficiary is past his/her own retirement age. The plan will be fully liquidated by the time the beneficiary reaches his/her late 80s. Since an estate can never qualify as a "designated beneficiary" an estate is never entitled to the life expectancy payout option.

The designated beneficiary also has the option, instead, to use the method that would have applied if the participant had left no designated beneficiary.

If the beneficiary is the participant's surviving spouse, different rules apply. The surviving spouse has more deferral options than a nonspouse beneficiary, including the option to roll over inherited benefits to her own retirement plan where they become "her" benefits and cease to be "inherited benefits." See Chapter 3 of *Life and Death Planning for Retirement Benefits*. Special rules also apply when there are multiple beneficiaries; see ¶ 6.3.02.

### ***6.2.01 When and why see-through trust status matters***

If retirement benefits are left to a "see-through trust" (¶ 6.2.03), the benefits can be distributed in annual instalments over the life expectancy of the oldest trust beneficiary, just as if the benefits had been left to an individual human Designated Beneficiary. In contrast, if the trust does not qualify as a see-through trust under the rules explained here, the retirement benefits must be distributed under the "no-DB rules." The no-DB (no Designated Beneficiary) rules require that all sums be distributed out of the plan within five or six years after the participant's death, if the participant died before his required beginning date (RBD); or (if the participant died *after* his RBD) over the remainder of what would have been the participant's life expectancy. Distribution over the life expectancy of a beneficiary usually provides substantially longer deferral than distribution under the no-DB rules.

The fact that a trust qualifies as a see-through trust does not mean that the trust is the best choice as beneficiary of the retirement benefits. Making benefits payable to a trust of which the participant's surviving spouse is the life beneficiary results in substantially less deferral than would be available (via the spousal rollover) for benefits left to the spouse outright *even if* the trust qualifies as a see-through; see ¶ 3.3.02(B) (Appendix A). Also, benefits left to a trust may be subjected to high trust income tax rates (¶ 6.5.01), even if the trust qualifies as a see-through.

Another reminder: Complying with the IRS's minimum distribution trust rules is not a prerequisite of making retirement benefits payable to a trust. If a trust named as beneficiary of a retirement plan "flunks" the rules, the trust will still receive the benefits; the trust just will not have the option of using the life expectancy of the oldest trust beneficiary as the Applicable Distribution Period for those benefits.

There are some situations in which it may make little or no difference whether the trust complies with the trust rules:

- ✓ **Client’s goals; beneficiaries’ needs.** It may be appropriate to sacrifice the deferral possibilities of the life expectancy payout method in order to realize the client’s other goals. See ¶ 6.4.05(D) for an example. Similarly, if it is expected that the retirement plan will have to be cashed out shortly after the participant’s death to pay estate taxes or for other reasons, there is no point in making the trust qualify as a see-through.
- ✓ **Trust beneficiary older than participant (plans that permit stretch payouts).** If the participant dies after his RBD, leaving benefits to a see-through trust, the ADP is the life expectancy of the participant or of the oldest trust beneficiary, whichever is longer. If the trust is not a see-through, the ADP is the participant’s life expectancy. If the participant is past his RBD, and the oldest trust beneficiary is the same age as (or older than) the participant, the ADP will be the same *whether or not the trust qualifies as a see-through*. Thus, qualifying as a see-through trust is IRRELEVANT if (1) the participant was past his RBD when he died and (2) the oldest trust beneficiary is either close in age to or older than the participant. *However*, if the plan in question pays death benefits only in the form of a lump sum, a trust-named-as-beneficiary will have to qualify as a see-through trust *even if* the participant died after his RBD and was younger than (or the same age as) the oldest trust beneficiary, IF the trust wants to stretch distributions over the participant’s remaining life expectancy. The trust will be able to use that “short stretch” payout only if it can have the lump sum transferred out of the lump-sum-only plan by direct rollover to an inherited IRA; and the nonspouse beneficiary rollover option is available only to individual beneficiaries and *see-through* trusts. See ¶ 4.2.04(C) of *Life and Death Planning for Retirement Benefits*.
- ✓ **Charitable trust.** Passing the trust rules is irrelevant for an income tax-exempt charitable remainder trust; see ¶ 7.5.04 of *Life and Death Planning for Retirement Benefits*.
- ✓ **Lump sum is best form of distribution.** There is no need to comply with the MRD trust rules if the trust qualifies for and plans to take advantage of a lump sum distribution income tax deal such as that available for “net unrealized appreciation” (NUA) of employer stock or for a participant born before 1936. See ¶ 2.4–¶ 2.5.

#### 6.2.02 MRD trust rules: Ground rules

Here are introductory points regarding how to deal with the “minimum distribution trust rules.”

- A. **Should you discuss MRDs in the trust instrument?** The MRD trust rules do NOT require the trust instrument to specify that the trustee must withdraw the annual MRD from the retirement plan. § 401(a)(9)(B) requires the MRD to be distributed from the plan or IRA to the trust-named-as-beneficiary whether or not the trust instrument mentions the subject.

Nevertheless, practitioners frequently do mention the requirement of withdrawing the MRD in the trust instrument, because it doesn't hurt to remind the trustee that he is supposed to comply with the minimum distribution rules. Also, including language dealing with the minimum distribution rules makes it clear that the drafter was aware of these rules and that the dispositive terms of the trust are not meant to conflict with them. In a marital deduction trust (§ 3.3.02, Appendix A) it is common to specify that the trustee must withdraw from the retirement plan "the greater of" the income (that the spouse is entitled to under the marital deduction rules) and the MRD.

Finally, if it ever becomes necessary to interpret the trust instrument in some unforeseen fashion, the court will look to the grantor's intent, so specifying that the grantor intends the trust to qualify as a see-through should help in that situation.

Avoid tying trust distributions too tightly to the minimum distribution rules, which could result in the beneficiary's receiving more or less than the trust-grantor envisioned if the minimum distribution rules are changed. This happened when § 401(a)(9)(H) suspended minimum required distributions for the year 2009. Under a trust that permitted the trustee to distribute to the beneficiary ONLY the "required" distribution and nothing else, the beneficiary received no distributions at all in 2009.

- B. Benefits and proceeds thereof.** For purposes of minimum distribution rule testing, a trust's interest in a retirement plan includes not just the retirement plan itself and the distributions from the retirement plan, but also the proceeds resulting from the trust's reinvestment of the retirement plan distributions. Reg. § 1.401(a)(9)-5, A-7(c)(1), third sentence.
- C. Benefits pass from one trust to another.** If the beneficiary of the trust is *another* trust, then *both* trusts must qualify under the trust rules. Reg. § 1.401(a)(9)-4, A-5(d). (Note: the IRS seems to ignore this requirement in some letter rulings.) However, if the second trust can be disregarded under the rules discussed at ¶ 6.3, the second trust does *not* need to comply with the trust rules. Under a conduit trust, for example, the trust's remainder beneficiaries are disregarded. ¶ 6.3.05(B). Thus, the remainder beneficiary of a conduit trust can be a trust that does *not* comply with the trust rules.
- D. Who tests compliance?** The person primarily responsible for verifying that the trust qualifies as a see-through trust is the trustee. The trustee is the one who must comply with the minimum distribution rules by correctly calculating (and taking) the annual required distribution, because the trust will have to pay the penalty for failure to take the MRD. § 4975. The trustee should obtain a legal opinion regarding the trust's qualification as a see-through trust. The plan administrator of a QRP also cares about compliance, because failure to comply could lead to plan disqualification.

### 6.2.03 *What a "see-through trust" is; the five "trust rules"*

The Code allows retirement plan death benefits to be distributed in annual instalments over the life expectancy of the participant's Designated Beneficiary. ¶ 6.2.00. Although the general rule is that a Designated Beneficiary must be an *individual*, the regulations allow you to name a *trust* as

beneficiary and still have a Designated Beneficiary for purposes of the minimum distribution rules. Reg. § 1.401(a)(9)-4, A-5(b), contains the IRS’s four “minimum distribution trust rules” (also called the MRD trust rules):

1. The trust must be valid under state law. ¶ 6.2.05.
2. “The trust is irrevocable or will, by its terms, become irrevocable upon the death of the” participant. ¶ 6.2.06.
3. “The beneficiaries of the trust who are beneficiaries with respect to the trust’s interest in the employee’s benefit” must be “identifiable...from the trust instrument.” ¶ 6.2.07.
4. Certain documentation must be provided to “the plan administrator.” ¶ 6.2.08.

If the participant dies leaving his retirement benefits to a trust that satisfies the above four requirements, then, for most (not all!) purposes of § 401(a)(9), the beneficiaries of the trust (and not the trust itself) “will be treated as having been designated as beneficiaries of the employee under the plan....” Reg. § 1.401(a)(9)-4, A-5(a). However, treating the trust beneficiaries as if they had been named as beneficiaries directly does not get you very far if the trust beneficiaries themselves do not qualify as Designated Beneficiaries. Accordingly, Rule 5 is that:

5. All trust beneficiaries must be individuals. ¶ 6.2.09–¶ 6.2.11.

The IRS calls a trust that passes these rules a **see-through trust**, because the effect of passing the rules is that the IRS will look through, or see through, the trust, and treat the trust beneficiaries as the participant’s Designated Beneficiaries, just as if they had been named directly as beneficiaries of the retirement plan, *with two significant exceptions*: First, “separate accounts” treatment is never available for purposes of determining the ADP for benefits paid to multiple beneficiaries through a single trust that is named as beneficiary; see ¶ 6.3.02(A). Second, a trust cannot exercise the spousal rollover option, even if it is a see-through. Reg. § 1.408-8, A-5(a).

#### ***6.2.04 Dates for testing trust’s compliance with rules***

The regulations give no specific testing date for the requirement that the trust must be valid under state law. The examples in the regulation refer to a trust that is valid under state law *as of the date of death*. ¶ 6.2.05. The irrevocability requirement must be met as of the date of death. ¶ 6.2.06.

For the documentation requirement deadline, see ¶ 6.2.08.

The requirement that the beneficiaries be identifiable must be met as of the date of death. However, if the trust flunks this requirement as of the date of death, it *may* be possible to cure the problem by actions prior to the Beneficiary Finalization Date. See ¶ 6.3.03.

The requirement that all beneficiaries must be individuals must be met as of the Beneficiary Finalization Date. See ¶ 6.2.10, ¶ 6.3.03.

### 6.2.05 *Rule 1: Trust must be valid under state law*

The first rule is that “The trust is a valid trust under state law, or would be but for the fact that there is no corpus.” Reg. §1.401(a)(9)-4, A-5(b)(1). There is no PLR, regulation, or other IRS pronouncement giving an example of a trust that would flunk this requirement.

A testamentary trust can pass this test, despite the fact that, at the moment of the participant’s death, the trust is not yet in existence; see Reg. §1.401(a)(9)-5, A-7(c)(3), Examples 1 and 2. There is no requirement that the trust be “in existence” or be funded at the time it is named as beneficiary or at the participant’s death. The requirement is that the trust, once it is funded with the retirement benefits *after* the participant’s death, must be valid under state law.

### 6.2.06 *Rule 2: Trust must be irrevocable*

The second rule is: “The trust is irrevocable or will, by its terms, become irrevocable upon the death of the” participant. Reg. § 1.401(a)(9)-4, A-5(b)(2); § 1.408-8, A-1(b).

Including in the trust the statement “This trust shall be irrevocable upon my death” is not necessary, since any testamentary trust or “living trust” automatically becomes irrevocable upon the testator’s or donor’s death, and therefore passes this test. On the other hand it does no harm to include this sentence, and inclusion may avoid the necessity of argument with possible future plan administrators and auditing IRS agents who may not be familiar with estate planning. See Form 4.1, Appendix B.

(Prior to revision of the minimum distribution regulations in 2001–2002, the IRS trust rules required the trust to be irrevocable as of the participant’s RBD. That rule has been abolished.)

A trustee’s power, after the participant’s death, to amend administrative provisions of the trust should not be considered a power to “revoke.” However, there is no authority or IRS guidance on this point.

Unfortunately, it is not clear what the IRS is driving at with Rule 2. The IRS has never given an example of a trust that does not become irrevocable at the participant’s death. Perhaps the regulation-writers are thinking of a situation where someone *other than* the participant has a power to “revoke” the trust after the participant’s death, as in some community property trusts.

**Steve Example:** Steve owns a \$1 million IRA that is community property. Under the law of Steve’s state, all property of both spouses, as an aggregate, is treated as community property, and the surviving spouse is permitted to satisfy her community property interest in the decedent’s assets by withdrawing any assets she chooses, up to the value of half the total value of all community property. Steve dies and leaves the IRA to a trust. The trust also holds \$600,000 of other assets, all of which are community property. Steve’s surviving spouse, Imelda, has the power to revoke the trust with respect to her community property interest in any property in the trust. Assume that her one-half community property interest in the \$1.6 million trust is \$800,000. That power would allow her to cancel (“revoke”) the trust with respect to as much as \$800,000 worth of the IRA. It appears that the trust is not irrevocable as to the IRA proceeds up to the maximum amount that is subject to the spouse’s power. Thus, the trust “flunks” the irrevocability rule to the extent of \$800,000 worth of the IRA.

However, flunking this trust rule doesn't matter if Imelda *exercises* her revocation power by withdrawing \$800,000 of the IRA from the trust. Since that portion of the IRA is no longer part of the trust, we don't care whether the trust passes the trust rules as to that portion. (For Imelda's ability to roll the \$800,000 distribution over tax-free to another plan, see ¶ 3.2.09 of *Life and Death Planning for Retirement Benefits*.)

Also, the spouse's power of revocation is not a problem to the extent that the IRA exceeds the spouse's 50 percent interest; if her power is to revoke only 50 percent of the trust, and the IRA represents more than 50 percent, the excess is not subject to the power, and so the rule is not violated as to that excess portion. See PLR 1999-18065.

Thus Rule 2 matters for Steve's trust, if at all, only to the extent that Imelda could, *but chooses not to*, satisfy her community property interest by withdrawing the IRA. If Imelda takes her \$800,000 by withdrawing \$200,000 from the IRA plus \$600,000 from the other assets, that leaves \$800,000 of the IRA still in the trust. Since Imelda *could* have revoked the trust as to an additional \$600,000 of the IRA that is still in the trust, the IRS might say the trust flunks Rule 2 as to \$600,000 worth of the IRA. There are no rulings on point.

### 6.2.07 Rule 3: Beneficiaries must be identifiable

"The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit" must be "identifiable within the meaning of A-1 of this section from the trust instrument." Reg. § 1.401(a)(9)-4, A-5(b)(3). The entirety of what "A-1 of this section" provides on the meaning of the word "identifiable" is the following: "A designated beneficiary need not be specified by name in the plan or by the employee to the plan...so long as the individual who is to be the beneficiary is identifiable under the plan. The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible to identify the class member with the shortest life expectancy." Reg. § 1.401(a)(9)-4, A-1.

For the effect of a power of appointment on the question of whether there are unidentifiable beneficiaries, see ¶ 6.3.11.

- A. Must be possible to identify the oldest trust beneficiary.** One meaning of this rule is that it must be possible to determine who is the *oldest person* (see "B," below) who could ever possibly be a beneficiary of the trust, because that is the person whose life expectancy is used as the ADP after the participant's death. Reg. § 1.401(a)(9)-4, A-5(c), § 1.401(a)(9)-5, A-7(a)(1).

Thus, if the trust beneficiaries are "all my issue living from time to time," and at least one such issue is living at the participant's death, the members of that class of potential beneficiaries are considered "identifiable," even though the class is not closed as of the applicable date, because no person with a shorter life expectancy can be added later. The oldest member of the class can be determined with certainty, because the participant's issue who are born after his death must be younger than the oldest issue of the participant who is living at his death. Reg. § 1.401(a)(9)-4, A-1.

Actually, there *is* theoretically a problem even with this common provision. If people who are issue by virtue of adoption are to be included, there is a potential for violating the rule. After the

participant's death, one of his issue could adopt someone who was born earlier than the person who was the oldest beneficiary of the trust when the participant died. It is not known whether the IRS would ever raise this "issue," but to avoid the problem the trust could provide that older individuals cannot later be added to the class of beneficiaries by adoption. See Form 4.3, Appendix B.

The rule that it must be possible to identify the oldest member of a class of beneficiaries is similar to the rule against perpetuities, in that the mere *possibility* that an older beneficiary could be added to the trust after the applicable date is enough to make the trust flunk this rule, regardless of whether any such older beneficiary ever is *actually* added (unless the potential older beneficiary can be disregarded under the rules explained at ¶ 6.3.04).

**Kit and Julia Example:** Kit leaves his IRA to a trust that is to pay income to his daughter Julia for life, and after her death is to pay income to her widower (if any) for his life, with remainder to Kit's grandchildren. Kit dies, survived by Julia and several grandchildren, none of whom disclaims his interest in the trust. Kit's trust flunks Rule 3, because Julia, after Kit's death, *could* marry a new husband who is older than she. Thus an older beneficiary *could* be added to this trust after the applicable date, and accordingly as of the applicable date we cannot "identify" the oldest beneficiary of the trust.

The "identifiable" test is applied, first, as of the date of death. If the trust flunks the requirement as of the date of death, but the "unidentifiable" beneficiaries are "removed" by some means prior to the Beneficiary Finalization Date (¶ 6.3.03), the trust would "pass." Unfortunately, if a trust flunks this test as of the date of death it often is not the type of mistake that can be fixed by the usual remedies of disclaimer or distribution. In the Kit and Julia Example, Julia's future husband(s) can't disclaim (and the trustee can't distribute their share of the trust by the Beneficiary Finalization Date) because we don't know who they are yet—that's the whole problem!

**B. What does "oldest beneficiary" mean?** For MRD purposes, "older" does not necessarily mean "born first"; it means having a shorter life expectancy. For MRD purposes, everyone born in the same year has the same life expectancy. See PLR 2002-35038.

**Paul Example:** Paul dies leaving his IRA to a trust that provides income to his issue *per stirpes*. Each issue has a separate share of the trust, with a testamentary power to appoint to any individual *other than* someone born before the year of birth of Paul's oldest issue living at Paul's death. Suppose Judy, born December 31, 1945, was Paul's oldest issue living at Paul's death. She can appoint her share to anyone born in 1945 or later, even if the appointee was born January 1, 1945, and so is almost a full year older than Judy. This power of appointment does not make the beneficiary "unidentifiable," because Judy still has the shortest life expectancy.

**C. Anyone in the world younger than a certain individual.** Sometimes the IRS expresses the "identifiable" requirement thus: "...the identity of the beneficiaries...can be determined by perusing...[the trust's] terms." PLRs 2005-21033, 2005-22012, and 2005-28031 use that exact phrase, and PLR 2002-09057 uses similar wording. What this phrase means, if anything, has yet to be established. If the IRS is suggesting that the "identifiable" test

requires only that the identity of the beneficiaries can be determined from the trust instrument then the rule is redundant: A trust under which the identities of the beneficiaries could NOT be determined by “perusing” the trust instrument would presumably not be valid under state law and therefore would violate Rule #1 (§ 6.2.05).

If the benefits are payable to a trust under which the trustee has absolute discretion to pay the benefits to “my son John and/or any individual in the world who is younger than John,” are the beneficiaries identifiable? Not in the normal sense of the word; though we know who the oldest *potential* beneficiary is (John), we cannot determine the identity of the beneficiaries by “perusing” the trust. We cannot know who is entitled to the benefits until the trustee makes his selection.

To date, however, the IRS has not used Rule 3 in any published ruling to disqualify trusts that are payable to broad or amorphous classes of unknown future beneficiaries or where access to the benefits is dependent on the trustee’s discretion. In PLR 2002-35038, the IRS approved a trust where the remainder interest could be appointed to any individual in the world who was not born in a year prior to the birth-year of the donor’s oldest issue living at the donor’s death. (This ruling is flawed, because the IRS fails to consider what becomes of the benefits if the power of appointment is not exercised; see § 6.3.11.)

#### **6.2.08 Rule 4: Documentation requirement**

The trustee of the trust that is named as beneficiary must supply certain documentation to the plan administrator. Reg. § 1.401(a)(9)-4, A-5(b)(4). In the case of a qualified plan, “**plan administrator**” is the statutory title of the person responsible for carrying out the plan provisions and complying with the minimum distribution rules; the employer must provide the name, address, and phone number of the plan administrator to all employees in the Summary Plan Description. In the case of an IRA, the IRA trustee, custodian, or issuer is the party to whom the documentation must be delivered. Reg. § 1.408-8, A-1(b).

**A. Post-death distributions.** The deadline for supplying the required documentation with respect to post-death distributions is October 31 of the year after the year of the participant’s death. Reg. § 1.401(a)(9)-4, A-6(b).

Although § 401(a)(9)(H) suspended minimum required distributions for the year 2009, the suspension did NOT extend this deadline. Thus, the trustee of a trust named as beneficiary of a decedent who died in 2008 (or 2009) still had to supply the required documentation no later than October 31, 2009 (or 2010), even though the trust was not required to take any MRD in 2009. Notice 2009-82, 2009-41 I.R.B. 491, Part V, A-4.

Here is the documentation required to be supplied to the plan administrator by that deadline. The trustee of the trust must *either*:

1. “Provide the plan administrator with a final list of all beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement) as of September 30 of the calendar year following the

calendar year of the employee's death; certify that, to the best of the trustee's knowledge, this list is correct and complete and that the [other "trust rules"] are satisfied; and agree to provide a copy of the trust instrument to the plan administrator upon demand..."; or

2. "Provide the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee's date of death."

Supplying a copy of the trust (#2) is an easier way to comply than providing a summary of the trust (#1). However, some retirement plans may require the summary-certification method of compliance (#1), since it relieves the plan administrator of the burden of reading the trust and determining whether it complies with the trust rules.

**B. Lifetime distributions.** The identity of the beneficiaries is irrelevant to the calculation of lifetime MRDs if the participant is using the Uniform Lifetime Table (§ 6.2.00). Therefore, the participant has no need to comply with the documentation requirement or other trust rules for his lifetime distributions *unless*: (1) the participant has named a trust as his sole beneficiary; (2) the participant's more-than-10-years-younger spouse is the sole beneficiary of the trust (see § 1.6.06, Appendix A); and (3) the participant wants to use the spouses' joint life expectancy (rather than the Uniform Lifetime Table) to measure his MRDs. In such cases, see Reg. § 1.401(a)(9)-4, A-6(a), regarding the documentation to be supplied.

No deadline is specified for supplying documentation in the case of lifetime MRDs. The conservative assumption would be that the deadline is the beginning of the distribution year in which the spouses' joint life expectancy is to be used as the ADP. The person who must fulfill this requirement is *the participant* (not the trustee, as is the case when the participant dies).

**C. If incorrect trust documentation is supplied.** If the participant (in the case of lifetime MRDs) or the trustee (in the case of post-death MRDs) completes the certifications incorrectly, or sends a copy of the wrong trust instrument to the plan administrator, the regulations let the *plan* off the hook.

The plan will not be disqualified "merely" because of these errors, provided "the plan administrator reasonably relied on the information provided and the required minimum distributions for calendar years after the calendar year in which the discrepancy is discovered are determined based on the actual terms of the trust instrument." Reg. § 1.401(a)(9)-4, A-6(c)(1). This wording suggests that the trust can still qualify as a see-through, even though incorrect information was provided to the administrator initially. The 50 percent penalty (which is payable by the person required to *take* the MRD; see § 1.9.02 of *Life and Death Planning for Retirement Benefits*) will be still be based on what should have been distributed "based on the actual terms of the trust in effect." Reg. § 1.401(a)(9)-4, A-6(c)(2).

### 6.2.09 *Rule 5: All beneficiaries must be individuals*

The result of compliance with the first four rules is that the trust beneficiaries will be treated, for *most* purposes, as if the participant had named them directly as beneficiaries (for exceptions see ¶ 6.3.02(A) and ¶ 1.6.06 (Appendix A)). The next step, therefore, is to make sure that these trust beneficiaries qualify as Designated Beneficiaries, *i.e.*, that they are individuals.

The first pitfall under this rule is that an estate is not an individual and therefore an estate cannot be a Designated Beneficiary. Therefore, if any part of the trust's interest in the benefits will pass to the participant's estate, there is a risk that the participant has no Designated Beneficiary; see ¶ 6.2.10. Once that hurdle is cleared we consider which trust beneficiaries, if any, can be disregarded in applying this rule. See ¶ 6.3.

### 6.2.10 *Payments to estate for expenses, taxes*

Typically, a trust provides that the trust must or may contribute funds to the decedent-trustor's estate for payment of the decedent's debts, expenses, and taxes. Such a provision raises a concern: If the estate (a nonindividual) is deemed to be a beneficiary of the trust, the trust will "flunk" Rule #5 (¶ 6.2.09).

However, despite suggestions in some PLRs (see, *e.g.*, PLR 9809059) that such a provision might disqualify a trust, there is no evidence that the IRS really does (or ever did) take this position. There is no published instance of any trust's ever having lost see-through status on account of such a clause. Many PLRs blessing see-through trusts do not even mention the subject; see PLRs 2002-08031, 2002-11047, 2002-18039, 2003-17041, 2003-17043, and 2003-17044.

If this type of clause *is* a problem, the risks of disqualification can easily be avoided either at the planning stage or (with a bit more care) in the post-mortem stage. Every letter ruling that *does* mention such a clause in a trust finds some reason why the trust nevertheless qualifies as a see-through. The IRS has recognized trusts as see-throughs, despite a trust clause calling for payments to the estate for debts, expenses, and/or taxes, where:

- ✓ The trust forbade the distribution of *retirement benefits* to the participant's estate (PLRs 2002-35038–2002-35041) or to any nonindividual beneficiary (PLRs 2004-10019–2004-10020). PLR 2004-53023 refers favorably to trust language that would "wall off" the benefits from being used to pay the decedent's debts and expenses (though the trust in question did not contain such language).
- ✓ The trustees asserted either that applicable state law prohibited use of the retirement benefits for this purpose (either directly, or indirectly through the application of some fiduciary standard), or that state law exempted such benefits from creditors' claims. See PLRs 2002-23065, 2002-28025, and 2006-08032 for examples of this language; other PLRs with similar language and holdings are 2001-31033; 2002-21056, 2002-21059, 2002-21061; 2002-35038; 2002-44023; 2004-10019–2004-10020; 2005-38030; and 2006-20028.

- ✓ The participant's estate was a beneficiary of the trust as of the date of death (by virtue of the estate's right to receive funds from the trust for payment of debts, expenses, and/or taxes), but the estate was "removed" as a beneficiary by complete distribution of its share of the trust prior to (or "as of") the Beneficiary Finalization Date (¶ 6.3.03). In PLRs 2004-32027–2004-32029, "as of" September 30 of the year after the year of the participant's death, the trustee had withdrawn, from the IRA that was payable to the trust, sufficient funds to pay all anticipated debts, expenses, and taxes of the participant's estate, including a reserve for income taxes that would be due on the IRA distributions themselves. The IRS ruled that on the applicable September 30 the only remaining beneficiaries of the trust were the participant's three children. Note that the "cash out" of a beneficiary (to make such beneficiary noncountable) can be made from the retirement benefits or from other trust assets, as long as the cashed-out beneficiary has no further interest in the retirement benefits as of the Beneficiary Finalization Date; see ¶ 6.3.03(A).
- ✓ The benefits were subject to the trust's contingent liability to pay additional estate taxes even *after* the Beneficiary Finalization Date (for example, if the tax bill were later increased as a result of audit) because there were no other assets available. PLRs 2004-32027–2004-32029, 2004-40031.

In short, there is no PLR or other IRS pronouncement in which the IRS has disqualified a trust either on the basis of a clause permitting the trustee to make payments to the participant's estate, or on the basis of the trust's actually making such payments. The IRS seems to agree it would be absurd to disqualify a trust merely because the retirement benefits payable to it may be liable for the participant's debts, administration expenses, and estate taxes. *All* retirement benefits are potentially subject to those liabilities regardless of whether a trust is the named beneficiary. While the threatening IRS hints on the subject make it worthwhile to draft to avoid the issue (see Form 4.2, Appendix B), there is little to fear even if a trust does contain this clause.

### ***6.2.11 Effect of § 645 election on see-through status***

A deceased participant's revocable trust can make an election to be treated as if it were the decedent's probate estate, or part of the probate estate, for income tax purposes during the administration period. § 645. A trust's "645 election" does not adversely affect the trust's see-through status. Even though the effect of such an election is that the estate and trust are treated as one entity "for all purposes of Subtitle A" of the Code (Reg. § 1.645-1(e)(2)(i), (3)(i)), "...the IRS and Treasury intend that a revocable trust will not fail to be a trust for purposes of section 401(a)(9) merely because the trust elects to be treated as an estate under section 645, as long as the trust continues to be a trust under state law." TD 8987, 67 FR 35731, 2002-1 C.B. 852, 857 ("Trust as Beneficiary").

## 6.3 MRD Rules: Which Trust Beneficiaries Count?

There is no special difficulty in determining whether the trust is valid under state law (Rule 1; ¶ 6.2.05), and irrevocable at the participant's death (Rule 2; ¶ 6.2.06), or that proper documentation has been supplied to the plan administrator (Rule 4; ¶ 6.2.08(A)). The hard part of testing a trust under the MRD trust rules is determining whether all trust beneficiaries are individuals (Rule 5; ¶ 6.2.09), and which trust beneficiary is the oldest (Rule 3; ¶ 6.2.07). The difficulty is determining which trust beneficiaries "count" for purposes of these two rules, and which beneficiaries may be disregarded. This involves a three-step process:

**Step 1:** Disregard any beneficiary who predeceased the participant.

**Step 2:** Determine whether certain beneficiaries may be disregarded because, even though they are beneficiaries of the *trust*, they will not share in the *retirement benefits* that are payable to that trust. See ¶ 6.3.01–¶ 6.3.02.

**Step 3:** Determine whether any beneficiaries who definitely *will* or potentially *could* share in the retirement benefits can be disregarded for some other reason, such as distribution or disclaimer of their benefits prior to the Beneficiary Finalization Date (¶ 6.3.03), or because they are "mere potential successors" to other beneficiaries (¶ 6.3.04–¶ 6.3.12).

### *6.3.01 If benefits are allocated to a particular share of the trust*

This ¶ 6.3.01 deals with the following situation: Retirement benefits are payable to a trust. Upon the participant's death, that trust is divided or split into two or more separate shares or "subtrusts," and the retirement benefits are allocated to fewer than all of such shares or subtrusts. A typical example would be a trust that divides, upon the participant's death, into a marital trust and a credit shelter trust and under which the benefits are allocated entirely to the marital trust; see Foster Example, ¶ 6.1.05(B). Another common case is a trust under which the benefits are entirely allocated to the share of one of multiple beneficiaries, or may *not* be used to fund a particular beneficiary's share.

The question discussed here is whether the "identifiable" and "all-beneficiaries-must-be-individuals" tests (MRD trust rules 3 and 5; ¶ 6.2.03) are applied to the entire trust (i.e., all possible beneficiaries of all shares and subtrusts created by the trust instrument), or rather are applied only to the beneficiary, share, or subtrust that ends up with the retirement benefits. Can we disregard beneficiaries of shares/subtrusts that do not receive any portion of the retirement benefits? As the following discussion shows, the answer to this question is surprisingly unclear. In analyzing any particular trust, it should not be assumed, that, merely because the benefits are allocated to one particular beneficiary, share, or subtrust, other trust beneficiaries, or beneficiaries of other shares or subtrusts, will be disregarded in applying the MRD trust rules.

[Note: If a single retirement plan benefit is left to a funding trust, and the trust then requires the benefit to be divided between or among multiple subtrusts or shares, a different question is presented. For example, I have been asked, when there is a formula bequest in the trust allocating

the maximum “credit shelter exemption amount” to the trust donor’s children with the rest of the assets passing to a charity, whether it is possible for the children’s share to use the oldest child’s life expectancy as the ADP, ignoring the nonindividual charitable beneficiary of the other share. This situation does not present the question “whether beneficiaries of the share that received no benefits can be ignored”; rather it is whether “beneficiaries of one share that received a share of the benefits can be ignored in determining the ADP with respect to the other share.” The answer in this case is that the charity, as beneficiary of the other share of the trust, can NOT be ignored in this case (because of the rule that separate accounts cannot be established with respect to multiple beneficiaries who acquire their interests through the same “funding” trust; see ¶ 6.3.02)—unless the charity’s entire share is distributed to it prior to the Beneficiary Finalization Date (see ¶ 6.3.03), which would probably not be possible in the case of a complicated formula bequest.]

- A. Beneficiaries with respect to the trust’s interest in the benefits.** Reg. § 1.401(a)(9)-4, A-5(a), tells us that, if the trust rules are complied with, “the beneficiaries of the trust (and not the trust itself)” will be treated as having been designated as beneficiaries by the employee. Although A-5(a) uses the phrase “beneficiaries of the trust,” all other references to the see-through trust concept specify that it is not *all* beneficiaries of the trust who are so treated, but rather only the beneficiaries of the trust *with respect to the trust’s interest in the employee’s benefit*. See Reg. § 1.401(a)(9)-4, Q-5; A-5(b)(3), (c); § 1.401(a)(9)-8, A-11 (last sentence).

Thus, the regulations seem to state that, even if the benefits are payable to a funding trust (such as the participant’s revocable living trust), we are not required to test all potential beneficiaries of the *funding trust*, if the benefits are allocated only to certain beneficiaries or to particular subtrusts created under the funding trust. Instead, this wording suggests, we look only at the beneficiaries of the subtrust(s) that actually receive(s) (or possibly only at beneficiaries that *could* receive) the retirement benefits, because they are the only beneficiaries “with respect to the trust’s interest in the benefits.” Unfortunately the IRS pronouncements (all of which are in private letter rulings) are not consistently supportive of this view; see (C)–(F) below. Sometimes the IRS seems to confuse this question with the entirely different issue of “separate accounts” treatment (¶ 6.3.02).

- B. Subtrust named directly as beneficiary of the benefits.** One thing is clear: If the participant’s beneficiary designation form names one or more particular subtrusts directly as beneficiary of the plan, rather than naming the funding trust, then the only beneficiaries who “count” for purposes of the trust rules are the beneficiaries of the subtrust(s) named as beneficiary. PLR 2006-07031. See Form 3.5, Appendix B, for a sample beneficiary designation form leaving benefits in separate shares directly to separate trusts established under a single trust instrument.
- C. Benefits allocated pursuant to trustee’s discretion.** If the trustee has discretion to decide which assets to use to fund which subtrust, and exercises its discretion by allocating the benefits to one particular beneficiary (or share), can other beneficiaries (or beneficiaries of other shares) be disregarded in applying the MRD trust rules?

This seems like the worst case for convincing the IRS that other beneficiaries of the trust should be ignored, yet ironically it is one situation in which there is a favorable PLR squarely on point! See PLR 2002-21061 (issued under the 2001 proposed regulations; see ¶ 1.1.01 of *Life and Death Planning for Retirement Benefits*), in which all pre-residuary beneficiaries of a trust (including charities) were ignored in determining the Applicable Distribution Period for retirement benefits payable to the trust, because the trustees (although they *could* have used the benefits to fund the pre-residuary bequests) were legally and financially able to, and did, satisfy the pre-residuary bequests out of other assets of the trust, and the pre-residuary beneficiaries did not have the right under state law to demand that they be paid out of the retirement benefits.

**D. Instrument mandates allocation; no formula.** If the trust instrument requires that the benefits *must* be allocated to a certain subtrust or to certain beneficiaries, or mandates that the benefits *cannot* be paid to certain beneficiaries or shares, regardless of the amount of the benefits or any other factors, beneficiaries of the shares to which the benefits absolutely cannot under any circumstances be allocated *should* be disregarded.

**Trevor Example:** Trevor’s IRA is payable to the Trevor Trust. At his death the assets of the Trevor Trust are to be divided between a marital trust and a credit shelter trust. The trust requires that all retirement benefits are to be allocated to the marital trust, even if that means the credit shelter trust is underfunded. Can the beneficiaries of the credit shelter trust be disregarded in applying the MRD trust rules?

It appears the answer to this should be yes, in view of PLR 2006-20026 (see “E”) and the language of the regulation (see “A”). However, in view of the IRS vagueness on these issues, if it is important to Trevor that the credit shelter trust beneficiaries be disregarded, he should name the marital trust *directly* as beneficiary of his IRA (see “B”).

In PLR 2004-40031, “A” left his qualified retirement plan (QRP) benefits to Trust T. Trust T required that the proceeds of any QRP be held in Subtrust U, which benefitted A’s grandchildren and younger issue. In determining that Trust T qualified as a see-through trust, of which the oldest grandchild was the oldest beneficiary, the IRS did not discuss the beneficiaries of any part of Trust T other than Subtrust U. While this *suggests* that the mandatory allocation of the benefits to Subtrust U required that beneficiaries of other subtrusts be disregarded, the ruling does not actually state that there *were* any other subtrusts, or any beneficiaries of Trust T who were not also beneficiaries of Subtrust U, so this ruling is not helpful.

Some PLRs mention, as part of a favorable ruling on see-through trust status, the fact that the trust in question forbade the distribution of retirement benefits to the participant’s estate. These PLRs *imply* that the IRS will disregard trust beneficiaries who are forbidden, by the terms of the trust, to share in the retirement benefits. However, these rulings are not conclusive, because the IRS has never on the record ruled that a trust was not a see-through trust merely because the benefits were subject to an obligation to contribute to payment of the deceased participant’s debts, expenses, or estate taxes. See ¶ 6.2.10.

- E. Mandated allocation pursuant to formula.** Many trusts that create a marital and credit shelter trust (or other subtrusts) by means of a formula specify that retirement benefits are to be allocated to a particular subtrust to the extent possible, and used to fund other subtrusts only if there are no other assets that can be used for such purpose. If the formula and the “to the extent possible” language compel the trustee to allocate the benefits entirely to (say) the marital trust, can the credit shelter trust beneficiaries be disregarded in applying the trust rules?

The PLRs on point are contradictory. In PLR 1999-03050, decided under the proposed regulations (see ¶ 1.1.01 of *Life and Death Planning for Retirement Benefits*), the IRS ruled that beneficiaries of other shares could *not* be disregarded; the ruling dealt with this as a “separate accounts” issue (see ¶ 6.3.02). However, in PLR 2006-20026, involving an IRA and QRP payable to “Trust T,” the IRS ruled exactly the opposite way. Trust T was to be divided into Subtrusts A and B upon the participant’s death by means of a formula. As a result of applying the formula, the benefits “had to be allocated to Subtrust B.” The ruling then proceeded to analyze only Subtrust B, with no mention of the terms or beneficiaries of Subtrust A. This suggests that the IRS has changed its mind since PLR 1999-03050, and is willing to ignore the beneficiaries of other trust shares, where the funding formula forces the trustee to allocate the benefits to one particular share.

- F. Mandatory allocation under state law.** If applicable state law mandates that the benefits be allocated to one particular beneficiary, subtrust, or share, do we disregard beneficiaries of all other shares in applying the MRD trust rules? The IRS has ruled both ways on this question. In PLRs 2005-28031–2005-28035, the IRS said “no”; these rulings offer no argument or basis for the conclusion. In contrast, PLR 2007-08084 seems to suggest that beneficiaries whose shares cannot (because of applicable state law standards) be funded with the retirement benefits CAN be disregarded.

### 6.3.02 *Separate accounts: benefits payable to a trust or estate*

For ease of reference, this discussion will deal with inherited IRAs. Though the same rules apply to all types of retirement plans subject to the minimum distribution rules, “separate accounts” treatment almost always involves inherited IRAs (including Roth IRAs).

When a participant leaves his IRA in fractional or percentage shares to multiple beneficiaries, the inherited account may, if this is permitted by the IRA agreement, be divided into separate “inherited IRAs,” one payable to each of the multiple beneficiaries. Once this division occurs, the separated accounts are treated as separate inherited IRAs for most purposes of the minimum distribution rules (generally, beginning the year *after* the division). See ¶ 1.8.01–¶ 1.8.02 of *Life and Death Planning for Retirement Benefits*. However, there is a significant exception to the separate accounts rule for retirement benefits payable to a trust:

- A. No separate accounts for ADP purposes.** Separate inherited IRAs established after the participant’s death are NOT treated as separate accounts *for purposes of determining the Applicable Distribution Period* (even if the division into separate accounts occurs on or

before December 31 of the year after the year of the participant's death), if the division into separate accounts occurs by operation of a single trust that is named as beneficiary. See Reg. § 1.401(a)(9)-4, A-5(c), as applied in PLRs 2003-17041, 2003-17043, 2003-17044, and 2004-32027–2004-32029.

Accordingly, if a participant wants a life expectancy payout to be available for each of multiple beneficiaries based on each such beneficiary's *own* life expectancy (or for each of multiple separate trusts based on the life expectancy of the oldest beneficiary of *each* such trust), the participant should name the individuals (or trusts) directly as beneficiaries *in the beneficiary designation form*, rather than naming a single funding trust as beneficiary of the retirement plan. See PLR 2005-37044 and Form 3.5, Appendix B.

Prior to issuance of the final minimum distribution regulations in 2002, separate accounts treatment *was* available for multiple beneficiaries taking under a single trust. See PLR 2002-34074 (issued in May 2002, after the final regulations were issued, though this PLR was decided under the proposed regulations). In this PLR, benefits were payable to a trust that terminated and was distributed in equal shares to the participant's children immediately upon his death. In one of its best-reasoned PLRs ever, the IRS stated that the MRD trust rules require treating the trust beneficiaries as if they had been named directly as the participant's beneficiaries, so the children's interests qualified as separate accounts even though the named beneficiary was a trust.

Perhaps because this result was so clear and logical the IRS promptly abandoned it. A new sentence appeared for the first time in the final regulations: "...the separate account rules under A-2 of § 1.401(a)(9)-8 are not available to beneficiaries of a trust with respect to the trust's interest in the employee's benefit." Reg. § 1.401(a)(9)-4, A-5(c). The new sentence was not contained in either set of proposed regulations, so there was no opportunity for public comment on this 180° change in the IRS's position.

Accordingly, the individuals who obtained PLR 2002-34074 wasted their money. The ADP for their benefits must be redetermined (for years after 2002) under the final regulations, and under the final regulations the ADP for their benefits will be based on the oldest trust beneficiary's life expectancy.

For the record: Continuing its habit of ruling both ways on MRD trust questions (see ¶ 6.3.01(E), (F)) the IRS in PLRs 2002-35038–2002-35041 ruled exactly the opposite, and allowed separate accounts treatment for benefits left to a trust, under the final regulations!

**B. Separate accounts for purposes other than ADP.** Although Reg. § 1.401(a)(9)-4, A-5(c), states that separate accounts cannot be established *for any purpose of the minimum distribution rules* for benefits that are left to multiple beneficiaries through a single funding trust, PLRs make clear that in fact the IRS means such separate accounts CAN be established for all MRD purposes *other than* determining the ADP. Thus, for example, if an IRA is payable to a trust that is to terminate immediately upon the participant's death and be distributed outright to the decedent's three children, the trust can divide the IRA into separate inherited IRAs and transfer one such separate inherited IRA to each of the children (see ¶ 6.1.05). Thereafter, the children's respective separate inherited IRAs (or "sub-IRAs" as the IRS calls them in some PLRs) will be treated as "separate accounts" for all minimum

distribution purposes *except* determination of the ADP. The ADP for all three children's shares will continue to be based on the life expectancy of the oldest child. See PLRs 2000-13041 and 2002-35038–2002-35041.

This result is not strictly in accordance with the regulations. If separate accounts “exist” but are not recognized for MRD purposes, then the regulation provides that: “the separate accounts *will be aggregated for purposes of satisfying the rules in section 401(a)(9)*. Thus, *...all separate accounts...will be aggregated* for purposes of section 401(a)(9).” Reg. § 1.401(a)(9)-8, A-2(a)(1) (emphasis added). Based on this language, the IRS has ruled (as one would expect) that the oldest trust beneficiary's life expectancy (in the case of benefits payable to, and transferred out of, a see-through trust), or the applicable no-DB rule (in other cases) continued to apply to all the split-up accounts.

However, in these PLRs, each such separate account *was clearly and definitely treated as a separate account for all MRD purposes* other than determination of the ADP, i.e., the MRD for each successor beneficiary was determined solely by reference to his or her separate account, without regard to the balances of (or distributions from) the other separate accounts. See PLRs 2006-46025, 2006-46027, and 2006-46028–2006-47030. This bifurcated result (accounts treated as separate accounts for some but not all MRD purposes) is contrary to the IRS's own regulation. See Reg. § 1.401(a)(9)-8, A-2(a)(1). What the regulation “really means” (apparently) is that separate accounts treatment IS available for benefits that are payable to different beneficiaries through an estate or trust, for all purposes other than determining the ADP.

Similarly, the IRS has allowed separate accounts treatment for all purposes other than determining the ADP for retirement benefits that pass through an estate. See PLRs 2006-46025; 2006-47029 and 2006-47030, in which two children inherited an IRA through their parent's estate and were allowed to split it into two separate inherited IRAs, one payable to each child. Even though the IRS ruled that “separate account treatment” was not available, the IRS *also* said the accounts *would be treated as separate accounts*, i.e., each child's MRDs would be determined solely with respect to his “sub-IRA.” What the IRS apparently meant was, separate accounts would not be available *for ADP purposes*. PLRs 2006-46025, 2006-46027, and 2006-46028 (involving three children who inherited through a parent's estate) are similar, as is PLR 2012-08039.

**C. Drafting to achieve separate accounts under one trust instrument.** If a participant wants to leave his IRA in separate shares, with each share to be held in trust for a different beneficiary, AND wants each such IRA-share to be payable over the life expectancy of the primary beneficiary for whom it is held, the participant should take the following two steps:

**Step 1:** He must cause a separate trust to be established for each such beneficiary. These separate trusts can be established (i.e. set up and funded) after his death, and can all be established under a single trust instrument, as long as each such trust is (at the time it receives the inherited benefits) a separate trust under applicable state law, with its own taxpayer identification number (TIN) and filing its own annual tax return. It is not possible to have separate account treatment for any MRD purpose for shares of a single IRA that are payable to a single trust that has multiple beneficiaries,

even if the multiple beneficiaries have “separate shares” under the single trust for other income tax purposes (§ 6.5.05).

**Step 2:** He must name each such to-be-established separate trust directly as a beneficiary of his retirement plan. He can do this either by establishing a separate IRA during his lifetime that is payable only to that particular trust, or by having a single IRA that is payable in specified shares to the respective trusts. See Form 3.5, Appendix B.

#### **D. Example of how separate accounts work under a single trust.**

**Thorfinn Example:** Article III of Thorfinn’s will creates a testamentary trust. The trust provides that, upon Thorfinn’s death, all trusts assets are to be divided equally between two separate trusts, one for Child A (age 50) and one for Child B (age 40). Article IV of the will contains the terms of each child’s trust. Thorfinn names as beneficiary of his 401(k) plan “The trust created under Article III of my will dated [date].” Thorfinn names as beneficiary of his IRA, “One-half to the Trust for the benefit of Child A under Article IV my will dated [date], and one-half to the Trust for the benefit of Child B under Article IV of my said will.” Assume both children’s trusts qualify as “conduit” see-through trusts (§ 6.3.05). Here are the steps the trustee takes and the minimum distribution results:

Step 1: The trustee opens bank accounts for the two children’s trusts established under Article IV of Thorfinn’s Will, and obtains TINs for them.

Step 2: The trustee causes the inherited IRA to be divided into two separate inherited IRAs, one titled “Thorfinn, deceased, IRA payable to Trust for Child A” and the other titled “Thorfinn, deceased, IRA payable to Trust for Child B.” Because the two children’s trusts were named separately as beneficiaries under Thorfinn’s IRA beneficiary designation form, and because the trustee “physically” divides the IRA into separate inherited IRAs by December 31 of the year after the year of Thorfinn’s death, the ADP for each child’s trust’s inherited IRA is the life expectancy of the child who is the “conduit” beneficiary of such trust.

Step 3: The trustee instructs the 401(k) plan administrator to transfer the inherited 401(k) benefits into two separate inherited IRAs, one payable to the trust for Child A and one payable to the trust for Child B. See § 6.1.05. See Step 4 for details and MRD results.

Step 3, alternate: The 401(k) plan administrator may not be willing to transfer the benefits directly to the separate inherited IRAs in the name of each child’s trust. It may be willing only to transfer the benefits to a single inherited IRA titled “Thorfinn, deceased, payable to Thorfinn Testamentary Trust.” In this case, the trustee will establish a new single inherited IRA so titled, then, after that IRA receives the 401(k) benefits by direct rollover, the trustee might divide it into two new separate inherited IRAs, one payable to each child’s separate trust.

Step 4: The ADP for the inherited IRAs that were established via direct rollover from Thorfinn’s 401(k) plan will be, in each case, the life expectancy of Thorfinn’s older child (Child A), because

Thorfinn’s beneficiary designation form for the 401(k) plan named the single “funding” trust as beneficiary. Unlike the IRA beneficiary form, it did not specify separate portions payable to the multiple beneficiaries (i.e., the two children’s trusts), so the division into separate accounts occurred at the “trust level” rather than at the “beneficiary designation form level.”

### 6.3.03 *Beneficiaries “removed” by Beneficiary Finalization Date*

A person or entity who is a beneficiary of the participant’s retirement plan as of the date of the participant’s death ceases to “count” as a beneficiary if he, she, or it does not “remain” as a beneficiary as of September 30 of the calendar year following the calendar year of the employee’s death (the “Beneficiary Finalization Date”). Reg. § 1.401(a)(9)-4, A-4(a).

A beneficiary does not “remain” such if such beneficiary’s interest in the benefits has been eliminated by either distribution (see “A”), disclaimer (see “B”), or other means (see “C”). (Note: The *death* of a beneficiary prior to the Beneficiary Finalization Date would eliminate him as a beneficiary only if his rights did not pass to his estate; see ¶ 1.8.03(C) of *Life and Death Planning for Retirement Benefits*.)

Although § 401(a)(9)(H) suspended the minimum distribution rules for the year 2009, the suspension did NOT extend this deadline. Thus, the beneficiary of a participant who died in 2008 (or 2009) will be “countable” unless (through distribution, disclaimer, or otherwise) he, she, or it ceased to be a beneficiary no later than September 30, 2009 (or 2010), even though the beneficiary was not required to take any MRD in 2009. Notice 2009-82, Part V, A-4.

Here is how the Beneficiary Finalization Date concept applies to retirement benefits that are payable to a trust as beneficiary. The determination of who are the trust beneficiaries for purposes of determining the trust’s “see-through” status is made as of the date of death, but may be modified by one of the following methods:

- A. Distribution on or before September 30.** Suppose retirement benefits are payable to a trust that has multiple beneficiaries. For purposes of qualifying for a payout of these benefits based on the life expectancy of one or more young individual beneficiaries of the trust, the trustee may wish to “eliminate” one or more nonindividual beneficiaries of the trust (to satisfy the “all beneficiaries must be individuals” rule; ¶ 6.2.09) or one or more older beneficiaries (so the trust’s ADP will be based on the life expectancy of a younger “oldest trust beneficiary”; ¶ 6.2.01). There are three ways that distribution can be used to “eliminate” an older and/or nonindividual beneficiary; note in each case that such option is available only if permitted by the trust instrument.

One is to withdraw from the IRA, and distribute to the beneficiary you are seeking to remove, his, her, or its entire share of the benefits, so that, as of the Beneficiary Finalization Date, the remaining beneficiaries of the trust and of the retirement benefits are all individuals (or all younger individuals). For example, see PLRs 2004-49041–2004-49042, in which the participant left his IRA to a trust that was to be distributed, in specified percentages, to his wife and daughters. The wife took distribution of her percentage of the IRA in full by the Beneficiary Finalization Date (and rolled it over to her own IRA). Therefore she was disregarded in determining who was the oldest beneficiary

of the trust, and the older daughter's life expectancy was the ADP for both daughters' shares of the IRA.

Another way is to distribute other assets (not the retirement benefits) to the "undesirable" beneficiary in full payment of his, her, or its share of the trust, so that, as of the Beneficiary Finalization Date, the only remaining beneficiaries of the trust and of the benefits are the "desirable" individual beneficiaries. See PLRs 2006-08032, 2006-10026, 2006-10027, and 2006-20026 for examples of this technique.

Finally, the trustee could transfer 100 percent of the retirement benefits out of the trust, intact, to one or more of the individual trust beneficiaries, before the Beneficiary Finalization Date, so that, as of the Beneficiary Finalization Date, the (young, individual) transferee(s) is (or are) the only beneficiary(ies) of the benefits. The other (older and/or nonindividual) beneficiaries of the trust are disregarded because they have ceased to have any interest in the retirement benefits (do not "remain" as beneficiaries).

Merely allocating the benefits to one particular share of a trust would *not* be sufficient to allow beneficiaries of other shares of the trust to be disregarded, according to PLRs 2005-28031–2005-28035.

See discussion of PLR 2012-10045 at ¶ 6.1.05(C) for an example of a ruling where, for unknown reasons, this technique was not used.

- B. Qualified disclaimer by September 30.** If a beneficiary disclaims his entire interest by the Beneficiary Finalization Date, he no longer "counts" as a beneficiary. See ¶ 4.4.11(A) of *Life and Death Planning for Retirement Benefits*. If the disclaimant was the oldest beneficiary, the next oldest beneficiary's life expectancy will become the ADP. Reg. § 1.401(a)(9)-4, A-4(a). See PLRs 2004-44033 and 2004-44034, in which "A" died leaving her IRA to a trust for the life benefit of her sister, with remainder to A's two nieces. The sister (who was older than the nieces) disclaimed her interest in the trust, so that the two nieces became the sole beneficiaries, and the older niece's life expectancy became the ADP. Similarly, disclaiming a power of appointment can eliminate potential appointees who would otherwise be "unidentifiable" and cause the trust to flunk Rule 3 (¶ 6.2.07). See PLR 2004-38044, discussed at ¶ 6.3.11(B).
- C. Other ways to "remove" a trust beneficiary.** The regulation cites distribution and disclaimer simply as *examples* of ways in which a person who was a beneficiary as of the date of death could cease to be a beneficiary as of the Beneficiary Finalization Date. Reg. § 1.401(a)(9)-4, A-4(a). Certain post-death amendments of the trust, made before the Beneficiary Finalization Date pursuant to express provisions included in the trust instrument, have been recognized by the IRS for MRD purposes; see PLR 2005-37044 (discussed at ¶ 6.3.12(C)), and PLR 2005-22012. Also, any beneficiary whose rights are terminated prior to the Beneficiary Finalization Date by operation of the trust terms would not be a countable beneficiary:

**Axel Example:** Axel dies leaving his IRA to a trust which provides that, until his daughter Rose reaches age 35, the trustee will use income and principal for Rose's benefit. When Rose reaches age

35, the trust will terminate and all trust property will pass outright to Rose. If Rose dies before reaching age 35, the trust will terminate and all property will pass to a charity. On the date of Axel's death, Rose is age 34½. Based on the terms of the trust as they exist at Axel's death, the trust has two beneficiaries, Rose and the charity, and "flunks" the MRD trust rules because one beneficiary is not an individual. Six months after Axel's death, Rose turns age 35 and becomes the sole beneficiary of the trust. Since this is before the Beneficiary Finalization Date, the trust qualifies as a see-through trust; the nonindividual beneficiary does not "remain" as a beneficiary as of September 30 of the year after the year of Axel's death.

#### ***6.3.04 Disregarding "mere potential successors"***

We now come to the last stand: trust beneficiaries who either definitely will, or someday may, receive a share of the retirement benefits that are payable to the trust, and who have not been "removed" as of the Beneficiary Finalization Date. Which members of this group can we disregard, if any?

Reg. § 1.401(a)(9)-5, A-7(c), the "**mere potential successor rule**," tells us which beneficiaries in this group are disregarded in applying the trust rules. Reg. § 1.401(a)(9)-4, A-5(c). The mere potential successor rule has been stated differently in each version of the regulations (1987 and 2001 proposed, 2002 final). The final regulation's version is as follows:

"(c). Successor beneficiary—(1) A person will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy...or whether a person who is not an individual is a beneficiary, *merely because the person could become the successor* to the interest of one of the employee's beneficiaries after that beneficiary's death. However, the preceding sentence does not apply to a person who has any right (including a contingent right) to an employee's benefit beyond being a *mere potential successor* to the interest of one of the employee's beneficiaries upon that beneficiary's death." Emphasis added.

How does the "mere potential successor" rule apply to a trust? For purposes of testing trust beneficiaries for "mere potential successor" status, the world can be divided into two types of trusts: "conduit trusts" (§ 6.3.05–§ 6.3.06) and "accumulation trusts" (§ 6.3.07–§ 6.3.11).

#### ***6.3.05 Conduit trust for one beneficiary***

"Conduit trust" is not an official term. It is a nickname used by practitioners (and occasionally by the IRS) for one type of see-through trust, namely, a trust under which the trustee has no power to accumulate plan distributions in the trust. The IRS regards the conduit beneficiary as the sole beneficiary of the trust; all other beneficiaries are considered mere potential successors and are disregarded.

See § 6.4.04(A) with regard to using a conduit trust for a disabled beneficiary, § 6.4.05(A) for a minors' trust, § 6.4.06(A) for a trust for the benefit of the participant's spouse. See § 6.3.06 regarding a conduit trust for multiple beneficiaries. See Forms 4.6–4.8, Appendix B, for sample conduit trust forms.

**A. What a conduit trust is.** Under a **conduit trust**, the trustee is required, by the terms of the governing instrument, to distribute to the individual trust beneficiary any distribution the trustee receives from the retirement plan (1) after the participant's death and (2) during the lifetime of such beneficiary. The trustee has no power to retain inside the trust ("accumulate," in IRS terminology) *any* plan distribution that is made after the donor's death during the lifetime of the individual conduit trust beneficiary. Note that:

- ✓ The "conduit" provision must come into effect immediately upon the participant's death. If the conduit requirement does not begin to apply until some later point in time (such as after the later death of the participant's surviving spouse) the trust is *not* a conduit trust; see ¶ 6.3.12(B). A trust cannot start out as an accumulation trust (say, during the life of the spouse), then flip to being a conduit trust for the remainder beneficiary (say the children) after the life beneficiary's death and still qualify as a see-through. The reason is that the trust may have *already* accumulated plan distributions (during the spouse's lifetime), so the trust does not meet the definition of a conduit trust at the participant's death.
- ✓ The trustee must pay out *all* distributions the trust receives from the retirement plan, not just "minimum required distributions."

As the IRS describes it in Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2, "*all amounts* distributed from A's account in Plan X to the trustee while B is alive will be paid *directly* to B upon receipt by the trustee of Trust P... *No amounts* distributed from A's account in Plan X to Trust P are accumulated in Trust P during B's lifetime for the benefit of any other beneficiary." Emphasis added.

**B. How a conduit trust is treated under the MRD rules.** With a conduit trust for one individual beneficiary, the retirement benefits are deemed paid "to" that individual beneficiary for purposes of the minimum distribution rules, and accordingly the "all beneficiaries must be individuals" test is met. As the IRS explains in Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2, under a trust with these terms, "...B [the conduit beneficiary] is the *sole designated beneficiary* of A's account in Plan X for purposes of determining the designated beneficiary under section 401(a)(9)(B)(iii) and (iv)...the residuary beneficiaries of Trust P are *mere potential successors* to B's interest in Plan X." Emphasis added.

All potential remainder beneficiaries (the persons who would take the remaining benefits if the conduit beneficiary died before the benefits had been entirely distributed) are disregarded because the IRS regards them as mere potential successors to the conduit beneficiary's interest.

The conduit trust for one individual beneficiary is a safe harbor. It is guaranteed to qualify as a see-through trust, and it is guaranteed that all remainder beneficiaries (even if they are charities, an estate, or older individuals) are disregarded under the MRD trust rules.

**C. Payments for beneficiary's benefit.** Payment to the legal guardian of a minor or disabled beneficiary should be considered payment "to" the beneficiary for this purpose. See

¶ 6.3.12(A) regarding making the conduit payments to a trust that is a 100 percent grantor trust as to the beneficiary. See ¶ 6.4.04(A) regarding making the payments to a special needs trust in the case of a disabled beneficiary.

- D. Payment of trust expenses.** In PLRs 2004-32027–2004-32029, the IRS ruled that “The use of Trust T assets to pay expenses associated with the administration of Trust T (in effect, expenses associated with the administration of the Trust T assets for the benefit of [the participant’s three children])...does not change” the conclusion that the trust had only individual beneficiaries. The IRS refers to “Trust T” in PLRs 2004-32027–2004-32029 as “a valid, conduit, see-through trust,” even though the trust terminated immediately upon the death of the participant and was distributed outright to the participant’s three children. In other words, Trust T was not the “classic” conduit trust that remains in existence after the participant’s death, passing out all plan distributions to the conduit beneficiary. Nevertheless, since the IRS calls it a “conduit trust,” the conclusion that payment of trust expenses out of the retirement plan assets does not adversely affect conduit status should remain valid. In PLR 2006-20026, the IRS blessed a conduit trust under which “asset management fees” would be paid directly to the trustee of the conduit trust out of the retirement plan assets, and would “not flow through” the trust.
- E. Drawbacks of the conduit trust.** The conduit trust is not suitable for every situation, because it lessens the trustee’s control considerably. Also, to work as intended, the conduit trust depends upon the minimum distribution rules’ staying exactly as they are under present law; if changes in the law require or encourage faster distributions, the trust beneficiary will receive the money much sooner than the participant intended.

Practical problems include the apparent requirement of “tracing” retirement plan distributions. The trustee must show that each distribution received from the plan is paid “directly” to the conduit beneficiary “upon receipt” by the trustee. Thus, the plan distributions need to bounce into and out of the trustee’s bank account in short order. Possibly the trustee could arrange to have distributions sent directly from the IRA or plan to the conduit beneficiary (bypassing the trust’s bank account).

There is no indication that the trust can take “credit” for distributing to the conduit beneficiary something other than the actual distribution received from the retirement plan. For example, suppose the minimum distribution from the IRA to a particular conduit trust for a particular year is \$10. Early in the year (before taking any distribution from the IRA) the trustee pays \$15 to the conduit trust beneficiary (from other assets of the trust). Now the trustee receives the \$10 MRD from the IRA. The trustee apparently must pass the \$10 IRA distribution out to the conduit beneficiary upon receipt by the trust, even though the trustee has already paid the beneficiary more than that amount during the year in question.

There is also the risk that the trust will receive a larger-than-intended distribution by mistake. There are cases where a trustee has requested a small distribution, or even just sent in the paperwork to have the IRA titled as an inherited IRA payable to the trust, and the IRA provider has erroneously cashed out the entire IRA and placed the funds in a taxable account in the name of the trust. One

negative effect of such an erroneous distribution is loss of deferral (because a nonspouse beneficiary cannot “roll over” a distribution from an inherited plan, even if the distribution was made in error; see ¶ 4.2.02(A) of *Life and Death Planning for Retirement Benefits*). The negative effects are compounded if the erroneous distribution is paid to a conduit trust, under which the trustee is compelled to immediately pass out the entire plan distribution to the conduit beneficiary (even if that has the effect of terminating the entire trust).

Finally, the conduit trust does not work for a client whose goal is to keep the retirement plan proceeds in the trust for the benefit of later beneficiaries. If the conduit beneficiary lives to a normal life expectancy he will have received all or almost all of the benefits and the remainder beneficiary will receive little or nothing.

**F. Conduit trust drafting pointers.** There are two ways to create a conduit trust. One is by including “conduit” provisions (that apply only to the participant’s retirement benefits) in a trust document for a trust that will also hold other assets. The other approach is to have a separate “stand-alone” trust that holds no assets other than retirement benefits that are eligible for a life expectancy payout. See ¶ 6.4.03. A participant considering leaving benefits to a stand-alone conduit trust might consider using an “individual retirement trust” (IRT) instead. ¶ 6.1.07.

**G. Conduit trusts for successive beneficiaries.** Here is a question that comes up repeatedly regarding conduit trusts:

*Question:* If there is a conduit trust for one beneficiary (call him Child), and after that beneficiary’s death the trust converts to being a conduit trust for another beneficiary (call her Grandchild), does the ADP switch to the life expectancy of the beneficiary of the second trust (Grandchild in this example) when the first conduit beneficiary dies? Or if there is a conduit trust for the benefit of the participant’s spouse (“Spouse”), which passes to the children at her death, does the trust switch to using the children’s life expectancy as the ADP after Spouse dies?

*Answer:* No. The ADP is always and irrevocably established at the participant’s death based on the life expectancy of the participant’s Designated Beneficiary (or applicable “no-DB rule”). See ¶ 1.5.13 of *Life and Death Planning for Retirement Benefits*. For a rarely-applicable exception to this rule, see ¶ 1.6.05(C). By leaving benefits to a conduit trust of which Child (or Spouse) is the conduit beneficiary, the result you get is that the ADP for benefits payable to the trust is the single life expectancy of Child (or Spouse). But that’s ALL you get: Just because you use a conduit trust does NOT mean that the ADP somehow switches or flips upon the Child’s (or Spouse’s) later death and allows the trust to stretch subsequent distributions over the *next* beneficiary’s life expectancy.

And remember, if Child lives to his life expectancy, there will be no further payments after his death that COULD be “stretched out” over somebody else’s life expectancy, because the entire retirement account will have been distributed to the trust, and all of those plan distributions will have been immediately paid out of the trust to Child, during Child’s life. If Child dies prematurely, Grandchild (or the trust for her benefit) can continue to withdraw the remaining benefits over the life expectancy of the now-deceased conduit beneficiary, Child. If the conduit beneficiary was Spouse

and she dies prematurely (i.e., before life expectancy payouts to her have used up most of the IRA), the successor beneficiaries get to use her remaining life expectancy as the ADP for any benefits remaining—unless the special “(B)(iv)(II)” rule applies (see ¶ 1.6.06, Appendix A), in which case the successor beneficiaries must use the 5-year rule.

The conduit trust concept *ends* at the death of the original conduit beneficiary. *There is no point in continuing “conduit” provisions of any type once the original conduit beneficiary has died.*

### 6.3.06 *Conduit trust for multiple beneficiaries*

Though the IRS’s only example on point deals with a conduit trust for just one beneficiary, the principle should also work with multiple beneficiaries. However, even more care is required to draft a conduit trust for multiple beneficiaries. To have a conduit trust for multiple beneficiaries, the requirements would be (based on the language in the IRS regulation):

1. All distributions the trust receives from the retirement plan must be immediately paid out to one or more of the conduit beneficiaries; and
2. As long as *any member* of the conduit group is living, no plan distributions can be accumulated in the trust for possible distribution to *other* beneficiaries.

**Warren Example:** Warren dies leaving his IRA to a trust for his children. The trust provides that, as long as any child of Warren is living, the trustee must pay out, to one or more of such children, in such proportions as the trustee deems advisable for their education, support, and welfare, any and all amounts the trustee receives from the IRA, upon receipt. The trust terminates when there is no child of Warren living who is under the age of 40, and the IRA is to be transferred in equal shares at that time to such of Warren’s children as are then living. Warren’s trust “works” as a conduit trust, since only the children can receive benefits from the IRA as long as any child is living. However, this approach does not provide any benefits for the issue of a deceased child of Warren.

**Davis Example:** Davis’s trust is the same as Warren’s, except that Davis’s trust provides that, upon the death of any child of Davis during the term of the trust, such child’s share would be held in trust for later distribution to the deceased child’s issue. Davis’s trust would *not* qualify as conduit trust, because plan distributions may be accumulated in the trust while some members of the conduit group are still living. In a conduit trust for one beneficiary (¶ 6.3.05), we “don’t care” what the trust terms provide after the death of the conduit beneficiary, because those subsequent beneficiaries are disregarded as mere potential successors to the conduit beneficiary. In a conduit trust for multiple beneficiaries, the “we don’t care” point is not reached until ALL of the permissible conduit beneficiaries have died.

### 6.3.07 *Accumulation trusts: Introduction*

Any trust that is not a conduit trust is called in this book an **accumulation trust** (the IRS does not use this term), meaning that the trustee has the power to accumulate plan distributions in

the trust. Under an accumulation trust (except, probably, in the case of a 100% grantor trust; ¶ 6.3.10) some or all of the potential remainder beneficiaries *do* “count” (i.e., they are not disregarded) for purposes of the MRD trust rules.

From Reg. § 1.401(a)(9)-5, A-7(c): “Thus, for example, if the first beneficiary has a right to all income with respect to an employee’s individual account during that beneficiary’s life and a second beneficiary has a right to the principal but only after the death of the first income beneficiary (any portion of the principal distributed during the life of the first income beneficiary to be held in trust until that first beneficiary’s death), *both beneficiaries must be taken into account* in determining the beneficiary with the shortest life expectancy and whether only individuals are beneficiaries.” Emphasis added.

While a conduit trust is guaranteed to pass the IRS trust rules, an accumulation trust may or may not pass the trust rules. Under an accumulation trust, it may or may not be easy to figure out which beneficiaries are disregarded as mere potential successors, because the meaning of this term is clear in some situations but unclear in others. The regulations offer no other guiding principles and contain only one example of an accumulation trust that passes the rules, the ambiguous Example 1 of Reg. § 1.401(a)(9)-5, A-7(c)(3): “Under the terms of Trust P, all trust income is payable annually to B [spouse of the deceased participant, A], and no one has the power to appoint Trust P principal to any person other than B. A’s children, who are all younger than B, are the sole remainder beneficiaries of Trust P. *No other person has a beneficial interest in Trust P.*” Emphasis added.

In this example, the IRS is making the point that B and the children of A are all considered “beneficiaries” of Trust P, so the surviving spouse is not the sole beneficiary, but her life expectancy is used as the ADP because she is the oldest beneficiary. This example is defective, however, because it does not explain what happens under “Trust P” if all of A’s children predecease B. Either the trust document or state law must have something to say on that point, but the IRS’s example is silent. Yet the only way we would be entitled to disregard the contingent beneficiaries who take in that case is if they are considered “mere potential successors” (¶ 6.3.04) to the interests of A’s children. The ambiguity is repeated in the IRS’s use of the same example in Rev. Rul. 2006-26, 2006-22 I.R.B. 939.

The IRS has resolved this ambiguity in several private letter rulings (which of course are not authoritative); see ¶ 6.3.08(A). Based on these PLRs, the meaning of Example 1 is that we need not consider who would take the benefits if the children of A predecease the participant’s surviving spouse B, because the children of A are outright (unlimited) beneficiaries, and accordingly any beneficiary who takes only if the children of A die before B is a “mere potential successor.”

### **6.3.08 Accumulation trust: O/R-2-NLP**

Under the approach exemplified in the PLRs discussed at “A” below, you test an accumulation trust by “counting” all successive beneficiaries down the “chain” of potential beneficiaries who could take under the trust, until you come to the beneficiary(ies) who or which will be entitled to receive the trust property *immediately* and *outright* upon the death of the prior beneficiary(ies). That “immediate outright” person, entity, or group is (or are) the last beneficiaries in the “chain” that you need to consider. If the immediate outright beneficiary(ies), and all prior beneficiaries in the “chain,” are individuals, then the trust qualifies as a see-through trust, with the

life expectancy of the oldest member of that group serving as the ADP. Any beneficiary who might receive the benefits as a result of the death(s) of the immediate outright beneficiary(ies) is ignored as a “mere potential successor.”

These tests are applied at the time of the participant’s death, “as if” the first trust beneficiary died immediately after the participant, and the next beneficiary in the chain died immediately after the first beneficiary, and so on until you reach the first “immediate outright” beneficiary, where you stop.

The tests are *not* re-applied at the later actual death of any beneficiary. It makes no difference who *in fact* inherits the benefits when the first beneficiary later dies. Rather, the “snapshot” of beneficiaries is taken once and only once, at the time of the participant’s death, based on the identities of beneficiaries *who actually survived the participant* and on the *hypothetical death of each of these beneficiaries* immediately after the participant’s death or immediately after the death of the prior beneficiary in the “chain.”

This type of trust is called an “**outright-to-now-living-persons**” (O/R-2-NLP) trust in this book. It is recommended that practitioners use conduit trusts (§ 6.3.05) and O/R-2-NLP trusts as often as possible when drafting trusts that are to be named as beneficiary of retirement benefits, since these are the only types of trusts as to which we have clear guidance that they “work.” For how to have an O/R-2-NLP trust for a disabled beneficiary, see § 6.4.04(B); for minors, see § 6.4.05(B); for the participant’s surviving spouse, see § 6.4.06(B).

- A. Authority for the O/R-2-NLP approach.** As explained at § 6.3.07, the only example of a nonconduit see-through trust in the regulations is ambiguous. In PLR 2004-38044, the IRS resolved that ambiguity. In this PLR, “A” died, leaving his IRA payable to a trust. The trust benefitted the participant’s spouse, B, for her life. Upon B’s death the principal would be divided among the participant’s “lineal descendants then living,” with each descendant’s share to be distributed to him outright (unless he was under age 30, in which case distribution was to be delayed until he had attained age 30).

At the time of the participant’s death, his spouse survived him, and he had three living children, C, D, and E, and apparently no deceased children. The three children had *already attained age 30* at the time of the participant’s death. Thus, if the spouse had died immediately after the trust’s establishment, the three children would have taken the trust principal (including the remaining retirement benefits) *outright and immediately*.

Since the spouse’s interest in the trust was “not unlimited” (she was entitled only to a life income interest, plus principal in the trustee’s discretion), it was “necessary to determine which other beneficiaries of Trust Y must be considered in determining who, if anyone, may be treated as Taxpayer A’s designated beneficiary....” In other words, if the first trust beneficiary is *not* entitled to outright distribution of the entire trust, or even of all distributions the trustee receives from the retirement plan, we must keep looking; we must also count as beneficiaries (for purposes of applying the tests in the IRS’s MRD trust rules #3 and #5) the beneficiary(ies) who will take the trust when the first beneficiary dies.

However, the ruling goes on to say that we can stop our search once we reach the children who are the apparent remainder beneficiaries under this trust. *Because they will take their shares*

*outright and immediately when the prior beneficiary dies*, we do not need to go further and find out who would take the benefits if any of these three children predecease the surviving spouse. From the ruling: “Since the right of each child to his/her remainder interest in the...[trust] was unrestricted at the death of Taxpayer A, it is necessary to consider only Taxpayers B through E [i.e., the spouse and the three children] to determine which of them shall be treated as the designated beneficiary of Taxpayer A’s interest in” the IRA. (Note: The ruling should say “to determine which of them shall be treated as the *oldest* designated beneficiary”; all of them are Designated Beneficiaries, and the oldest Designated Beneficiary’s life expectancy will be the ADP.) This is consistent with, and clarifies, Example 1 of Reg. § 1.401(a)(9)-5, A-7(c)(3).

Later PLRs 2005-22012, 2006-08032, and 2006-10026 confirm this interpretation of the regulation.

**B. Finding an “O/R” beneficiary (future issue don’t count).** The O/R-2-NLP trust requires the existence of at least one now-living person who would be entitled to outright distribution of the benefits upon the prior beneficiary’s death. It is not always easy to find a *younger individual* to name as outright immediate beneficiary after the first beneficiary’s death.

Future unborn issue can NOT be counted for this purpose because you cannot assume they will ever exist. See, *e.g.*, PLR 2008-43042, in which father died leaving his IRA to a trust for his son “C.” C was to receive all of the trust funds no later than age 40. If he died before reaching age 40, the trust would pass to C’s descendants, if any, otherwise to C’s “heirs at law.” At the time of father’s death, C had no descendants living. His “heir-at-law-apparent” was his mother. The IRS ruled that the countable beneficiaries of the trust were C and his mother. PLRs 2006-10026 and -10027 are similar.

It is not known whether a beneficiary *en ventre sa mere* can be counted for minimum distribution purposes.

**C. O/R-2-NLP trust example.** Here is a question received from a trustee attempting to apply the O/R-2-NLP concept to a trust.

*Question:* We are administering a trust that provides, “income to surviving spouse for life, remainder at spouse’s death in equal shares to the participant’s then living children, with the share of any child under age 40 to be held in trust for such child until he/she reaches age 40. If a child dies before reaching age 40, such child’s share passes outright immediately to such child’s issue, if any, otherwise to the participant’s then living issue if any, provided, that the amount passing to any child of the participant who is then under age 40 shall be added to such child’s share held under this trust; or, if there are no such issue then living, to individual Z.” The participant has just died, survived by his spouse and four children, all of whom are under age 40, and by individual Z. None of the children has any issue now living. I understand that, since “individual Z” is the first “outright immediate” beneficiary, we have to “count” him as a beneficiary along with the spouse and the children, but is he the “last” beneficiary we have to “count?” And when do we apply these tests— When the participant dies? At the subsequent death of the surviving spouse? Or when all the children die? Do

we have to worry about whether “Z” is living when the surviving spouse dies, or when the children *actually* die?

*Answer:* The way the regulation seems to work is this. We take a snapshot of the trust beneficiaries who are living at the moment the participant dies. We look at the “snapshot” to determine who would get the money if each successive beneficiary died RIGHT THEN, one minute after the participant (or one minute after the prior beneficiary, as the case may be). So: The spouse survived the participant, and she counts as a beneficiary. Then assume she dies one minute later, who comes next? The participant’s children. *If* they were all already over age 40 when the participant died, we could “stop counting” with them, because they would get the money *immediately outright* at the surviving spouse’s death in that case; see “A.”

However, because the children are under age 40 at the participant’s death, we have to assume that the children will not get the money immediately outright at the spouse’s later death (no matter how actuarially likely it is the children WILL all be over age 40 when the spouse ACTUALLY later dies). Because the children are under age 40 at the participant’s death, we have to see who would take the trust funds if all the children died immediately after the spouse who died immediately after the participant. We cannot count the children’s unborn future issue (see ¶ 6.3.08(B)), so we end up counting “individual Z” as a beneficiary because he is the first immediate outright beneficiary who is living at the participant’s death.

Note that we “don’t care” whether any child entitled to benefits will actually be over or under age 40 when the spouse ACTUALLY dies; we are looking at the hypothetical state of things as if she died immediately after the participant. We do not take any additional “snapshots” at the later ACTUAL death of the surviving spouse, nor do we care whether “Z” is ACTUALLY living when the spouse (or any child) later actually dies. That’s because the ADP for the trust is irrevocably and finally determined at the time of the participant’s death, based on the identity of the participant’s beneficiary(ies) at that time.

For limited exceptions to the conclusion that the ADP is irrevocably established at the participant’s death, see ¶ 6.3.03 (certain post-death distributions), ¶ 1.6.06(A) (Appendix A) (conduit trust for surviving spouse), and (in *Life and Death Planning for Retirement Benefits*) ¶ 4.4.11(A) (disclaimers), and ¶ 1.7.02 (requirement of survival clauses).

### **6.3.09 Accumulation trust: “Circle” trust**

One way to deal with the mystery of which beneficiaries are disregarded is to draft the trust so that there are no beneficiaries you *need* to disregard. If the trust property cannot be distributed to a nonindividual beneficiary, then it passes Rule 5 (¶ 6.2.09).

For example, if the trust provides “income to spouse for life, remainder outright to our issue living at spouse’s death; provided, if at any time during spouse’s life there is no issue of ours living, the trust shall terminate and be distributed to spouse,” it is impossible for the trust assets to pass to anyone other than spouse or issue, all of whom are individuals. If spouse dies before issue, issue get the benefits. If issue die before spouse, spouse gets the benefits. This is nicknamed a “circle trust” because the group of beneficiaries is a closed circle. This approach could be appropriate for a client who is leaving benefits to a credit shelter trust for the spouse only to save estate taxes for his issue,

and who would just as soon leave it outright to the spouse if it should happen that all the issue predecease the spouse.

This is also called the “last man standing” approach, because it provides for an accelerated termination if it should ever occur that only one member of the beneficiary-group is still living, with immediate outright distribution of the entire trust to that individual; see ¶ 6.4.05(B).

Note: Of course there is the possibility that simultaneous deaths may occur with the result that the benefits wind up passing to one or more beneficiaries’ estates (i.e., nonindividual beneficiaries). Based on Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 1, and the successful O/R-2-NLP PLRs (¶ 6.3.08(A)), this possibility is ignored when testing a trust for see-through status.

### ***6.3.10 Accumulation trust: 100 percent grantor trust***

Under the so-called “grantor trust rules,” a trust beneficiary who is a U.S. citizen or resident is treated for purposes of the federal income tax as the “owner” of trust assets if such beneficiary has the sole unrestricted right to withdraw those assets from the trust. See § 678(a)(1), § 672(f), Reg. § 1.671-3. If an individual is deemed the owner of all of the trust’s assets under § 678(a)(1), then retirement benefits payable to such trust *should be* deemed paid “to” such individual beneficiary for purposes of the minimum distribution rules, and the “all beneficiaries must be individuals” test would be met; however, there is no ruling on point.

In PLR 2000-23030, the decedent’s IRAs were payable to a trust that was a grantor trust as to the surviving spouse. The IRS ruled that a transfer of the decedent’s IRAs to or from this trust was deemed a transfer to or from the surviving spouse. See also PLR 2003-23012, in which the surviving spouse was recognized as the participant’s Designated Beneficiary under the annuity rules of § 72 when benefits were payable to a trust deemed owned by the spouse under the grantor trust rules. However, neither of these rulings discussed whether the trust in question *qualified as a see-through trust*. The IRS has always been more lenient in allowing a spousal rollover through a trust (see ¶ 3.2.09 of *Life and Death Planning for Retirement Benefits*) than in recognizing a trust as a see-through.

In PLRs 2006-20025 and 2008-26008 (discussed at ¶ 4.6.03(C), Appendix A), the IRS allowed beneficiaries who inherited IRAs outright to transfer their inherited IRAs to “grantor trusts” for their own benefit, again lending support to the conclusion that a grantor trust will be deemed “the same as” the individual who is treated as the 100 percent owner of the trust property for income tax purposes. But there is no specific ruling to the effect that a trust that is named as beneficiary of a retirement plan and that is a grantor trust as to a particular individual qualifies as a see-through trust.

Treating the trust beneficiary as the “owner” of the benefits for income tax purposes would have two significant results: Income taxes on the trust’s income would be imposed at the beneficiary’s rate; and (presumably) the remainder beneficiary would not be considered a beneficiary of the trust for purposes of the minimum distribution rules. Thus an estate, older individuals, or charities could be named as remainder beneficiaries (to succeed to whatever part of the trust was not distributed to or withdrawn by the owner-beneficiary during his life) without loss of the use of the owner-beneficiary’s life expectancy as the ADP. Similarly, a power of appointment that affected the trust property only after the death of the owner-beneficiary could be disregarded; see ¶ 6.3.11.

Under this model, the trust beneficiary would be given the unlimited right to withdraw the benefits (and any proceeds thereof) from the trust at any time. Until the beneficiary chose to exercise this right, the trustee would exercise ownership rights and responsibilities on the beneficiary's behalf, for example, by investing the trust funds, choosing distribution options, and distributing income and/or principal to or for the benefit of the beneficiary.

This type of trust would be uncommon, since anyone wanting to give such broad rights to the beneficiary would presumably leave the benefits outright to the beneficiary rather than in trust. However, this model could be useful for certain disabled beneficiaries (see ¶ 6.4.04(C)) or for a "qualified domestic trust" (QDOT) for the benefit of a noncitizen spouse (§ 2056(d)); see the *Special Report: Retirement Benefits and the Marital Deduction, Including Planning for the Noncitizen Spouse* (Appendix C).

### 6.3.11 Powers of appointment

If a remainder interest is subject to a power of appointment upon the death of the life beneficiary of the trust, all potential appointees, as well as those who would take in default of exercise of the power, are considered "beneficiaries," unless they can be disregarded under the rules discussed in this ¶ 6.3.

Under a conduit trust for a single beneficiary, the trust's remainder beneficiaries are disregarded. ¶ 6.3.05(B). Thus, the conduit beneficiary (or the trustee or anyone) can be given the power to appoint the trust assets remaining at the conduit beneficiary's death to anyone, even a charity, a non-see-through trust, an estate, or an older individual, and the trust will still qualify as a see-through with the ADP based on the conduit beneficiary's life expectancy. See, e.g., PLR 2006-20026. For a trust with multiple conduit beneficiaries, the same is not true; see ¶ 6.3.06.

With an accumulation trust, remainder beneficiaries generally must be counted. (The presumed exception is the 100 percent grantor trust; see ¶ 6.3.10.) Thus, if an accumulation trust (other than, presumably, a 100 percent grantor trust) is to qualify as a see-through, all such potential appointees, as well as those who will take in default of exercise of the power, should be: (1) identifiable (¶ 6.2.07), (2) individuals (¶ 6.2.09), who are (3) younger than the beneficiary whose life expectancy is the one the participant wants used as the ADP. The following examples illustrate the possibilities:

- A. **Power to appoint to "issue"** of the participant and/or spouse apparently is acceptable, because the power is limited to a small, clearly-defined group of "identifiable" younger individuals. See PLR 1999-03050 ("Trust B") approving a trust that granted the surviving spouse a testamentary power to appoint the principal "to and among the issue" of the participant and his spouse. If the power were not exercised, the property would pass at the surviving spouse's death to "the children or their issue, under the terms set forth in Trust M"; thus the potential appointees and the takers in default were the same group. A defect of this ruling is that the "terms" of "Trust M" under which the issue would take are not specified; see "E" below. Presumably the participant had some issue living at the time of his death, though curiously the PLR does not so state.

- B. Power to appoint to spouses of issue.** A power to appoint property to someone’s “spouse” is a classic example of creating a nonidentifiable beneficiary (unless it is limited to a particular identified spouse, or to spouses who are younger than the oldest trust beneficiary determined without reference to the power). See Kit and Julia Example, ¶ 6.2.07(A). In PLR 2004-38044, the participant’s surviving spouse had the power to appoint the trust at her death to the participant’s issue *and their spouses*; to enable the trust to qualify as a see-through, she disclaimed this power. See ¶ 6.3.03(B). As a result of the disclaimer of the power, the property would pass outright to the takers in default of exercise of the power, who were the decedent’s issue.
- C. Power to appoint to charity.** A trust that says “The trustee shall pay income to my spouse for life, and upon my spouse’s death the principal shall be paid to such members of *the class consisting of our issue and any charity* as my spouse shall appoint by her will,” would flunk this rule, because the benefits could pass under the power to a nonindividual beneficiary, the charity.
- D. Power limited to younger individuals.** See ¶ 6.2.07(C).
- E. Power to appoint to another trust.** Under many states’ laws, a power to appoint to individuals includes the power to appoint *in trust for* such individuals. The IRS has never commented on the effect of such a state law (or of an explicit power in an instrument to appoint to another trust). Since the regulations require that, if benefits are distributable under one trust to another trust, *both* trusts must comply with the rules (¶ 6.2.02(C)), it would appear that any power of appointment that could be exercised by appointing the benefits to another trust would cause the first trust to flunk the trust rules *unless* the power is limited to appointing only to other trusts that comply with the rules. One requirement of a see-through trust is that a copy of the trust be given to the plan administrator by October 31 of the year after *the participant’s* death (¶ 6.2.08(A)). Thus, the power could effectively not be exercised to appoint to a new trust; the power holder would be limited to appointing to other see-through trusts created by the participant at or prior to his death (if there are any such trusts).

### 6.3.12 *Combining two types of qualifying trusts*

As we have seen, there are several ways to qualify a trust as a see-through. What happens if you combine two methods in the same trust? Drafters sometimes look into that idea in an attempt to satisfy the client’s desire to prevent the beneficiary from ever actually gaining access to the retirement benefits.

- A. Conduit trust and 678 grantor trust.** If the trust beneficiary has the right to demand distribution of the entire trust to himself, it appears the trust qualifies as a see-through because it is a 100 percent grantor trust; see ¶ 6.3.10. A trust also qualifies as a see-through if the trustee is required to pass all plan distributions out to the beneficiary immediately (conduit trust; ¶ 6.3.05). What if the trustee is not required to automatically *distribute* all plan

distributions to the beneficiary, but the beneficiary has the right to demand immediate payment to himself of *all distributions the trustee receives from the plan*? The IRS position regarding such a hybrid grantor-conduit trust is not known. Such a trust does *not* conform with the regulation's description of a conduit trust.

- B. Conduit distributions must begin at participant's death.** Suppose a trust provides income to the participant's spouse for life, with remainder passing to the participant's issue, but with each issue's share to be held in trust until the beneficiary reaches age 30. To make the trust "pass" the trust rules, can the trust become a conduit trust for the issue on the surviving spouse's death? No. See ¶ 6.3.05(A).

Reminder: If the spouse *predeceases* the participant she does not "count" as a beneficiary, and terms that would have applied had she survived are *irrelevant*. If the spouse predeceases, you test the trust by looking **ONLY** at the terms that apply to the children's interests, so having a conduit trust for the children on the participant's death *if the spouse does not survive him* could be appropriate.

- C. "Switch" trusts.** Under a "switch" or "toggle" trust, the trust is set up as a conduit trust for one beneficiary, but a "trust protector" is given the power to convert the trust, by amendment, to an accumulation trust. The amendment power may require the trustee to also change the remainder beneficiaries of the trust, if some of the remainder beneficiaries under the conduit trust would not be suitable under an accumulation trust.

The benefit gained by this elaboration is the flexibility to cut down on the beneficiary's access to the retirement plan. This flexibility would be desirable if the beneficiary is in financial trouble. But by definition this approach is helpful in this way *only* if the beneficiary gets into trouble during a very narrow window of time—either just before the participant's death (too late for the participant to amend his estate plan) or just after it (before the Beneficiary Finalization Date, which is the deadline by which the trust protector must exercise the amendment power).

The approach is based on PLR 2005-37044, which involved a trust under which a trust protector had and exercised such an amendment power. Following court proceedings to reform the trust to the IRS's liking, the IRS ruled that the exercise of the amendment power did not cause the trust to lose its see-through status, because the trust protector's actions: carried out specific provisions adopted by the participant (i.e., the trust protector did not simply substitute some provisions of its own devising); were effective retroactively to the date of death and so could "be treated as a part of" the original trust instrument; and were "treated as a disclaimer under the laws of" the applicable state. The finding that state law treated this trust amendment as a "disclaimer" is mysterious because the trust protector's action was not a disclaimer and was nothing like a disclaimer.

Some advisors advocate the "switch" trust as a planning technique, seemingly regarding this single rather messy PLR as if it established an IRS-approved prototype trust. Yet the IRS's subsequent turn against post-death trust modifications (see PLR 2010-21038, and discussion at ¶ 4.5.06 of *Life and Death Planning for Retirement Benefits*) makes it unclear whether PLR 2005-

37044 could be duplicated today. An alternative view is that the “toggle” approach involves substantial complications, relying on a shaky “precedent,” to obtain a modest benefit.

## 6.4 Estate Planning with the MRD Trust Rules

Now that we understand the minimum distribution trust rules (see ¶ 6.2–¶ 6.3), the next step is to see how these the rules affect estate planning choices.

### 6.4.01 *Boilerplate provisions for trusts named as beneficiary*

Many practitioners would like to have a blanket trust form that will work for all clients’ situations without further fine tuning. This approach can be hazardous when dealing with retirement benefits.

It makes sense, if qualification for see-through trust status is important, to include a “boilerplate” provision either prohibiting the use of the retirement benefits for payments to the estate for debts, expenses, or taxes, or requiring that no such payments may be made from the retirement benefits either “at all” or “on or after the Beneficiary Finalization Date.” See ¶ 6.2.10 and Form 4.2, Appendix B. If there are no assets available to pay debts, expenses, and taxes other than the retirement benefits, consider specifying that only certain plans may be used for this purpose, so that only the plans authorized to be so used will be “tainted” and the other(s) can be exempted from this problem; or have the participant take withdrawals during life so his estate will have sufficient nonretirement assets to pay these items.

Similarly, include provisions that: the trust will be irrevocable at the participant’s death (¶ 6.2.06); certain adult adoptions occurring after the participant’s death will be ignored (¶ 6.2.07(A)); and property may not be appointed to a non-see-through trust. See Forms 4.1, 4.3, and 4.4, Appendix B. However, do not be misled into thinking that any trust that includes these “boilerplate” provisions automatically qualifies as a see-through trust, eligible to take minimum distributions based on the life expectancy of the oldest of the primary trust beneficiaries. This is absolutely NOT the case!

Qualification as a see-through trust depends on the substantive terms of the trust. A trust that provides “income to my spouse for life, remainder to the Salvation Army,” can NOT qualify as a see-through trust because of the “countable” nonindividual remainder beneficiary (namely the charity). Including a paragraph in such a trust to the effect that “retirement benefits cannot be paid to any nonindividual beneficiary” does not fix the problem; it just makes the trust even more defective because now (in this example) the remainder interest in the trust is not disposed of (and may therefore revert to the donor’s estate, another nonindividual beneficiary). A “boilerplate” provision prohibiting distributions of retirement benefits to nonindividual beneficiaries can cause problems:

**Heather Example:** Heather’s trust provides that, upon Heather’s death, the trust is divided into equal shares for her four children. Each child receives income for life from his or her share, plus principal in the trustee’s discretion for the child’s health, education and support. At death, each child can appoint the principal of such child’s share among Heather’s issue and any charity. If the child fails to exercise this power of appointment, such child’s share is paid to such child’s issue if any,

otherwise to the other children. The assets coming to this trust at Heather's death are Heather's \$1 million IRA and \$1 million of other assets. The existence of potential charitable remainder beneficiaries (as appointees under the children's powers of appointment) would mean that, under the multiple beneficiary rule, this trust would flunk the IRS's minimum distribution trust rules. The trust would not be able to use the life expectancy of the oldest child to measure MRDs from the IRA to the trust after Heather's death. It would be stuck with the applicable "no-DB rule" (see ¶ 7.2.02). Adding a blanket prohibition against paying retirement benefits to charity is *not* the best way to solve the problem in Heather's trust. For one thing, it is not clear that such prohibitions "work" under the MRD trust rules; see ¶ 6.3.01(D) of *Life and Death Planning for Retirement Benefits*.

For another, because the potential charitable gifts do not occur until each child dies, the trustee, in order to carry out a blanket prohibition against using retirement benefits to fund any charitable gift, would have to segregate the IRA (and all distributions from the IRA) from the other assets of the trust immediately upon Heather's death and keep them segregated for the duration of the trust. So instead of administering four trusts (one for each child) the trustee would end up administering eight trusts (one trust for each child's share of the IRA and IRA distributions, which could not be appointed to charity on the child's death, plus a separate trust for each child's share of the non-IRA assets, which *could* be appointed to charity on the child's death). That is the only way the trustee will be able to tell, when the child dies many years from now, which assets can be appointed to charity and which assets cannot be. If the trust instrument or local law does not clearly give the trustee authority to establish two separate trusts for each beneficiary, the trustee might have to go to court to get such authority.

Suppose the trustee sets up the eight separate trust shares. Now Child A needs a discretionary distribution of principal. Does it come out of the retirement assets trust for Child A? or the nonretirement assets trust for Child A? Again, this is a question that must be covered in the trust instrument (or, if it is not, the trustee might have to go to court for authority to pay out of one share or the other).

#### **6.4.02 Advance rulings on see-through trust status**

One expensive and time-consuming way to achieve certainty regarding the see-through status of a trust would be to seek a private letter ruling on this point while the client is still living. The IRS will not rule on "hypothetical" questions, but once the trust is named as the participant's beneficiary, the IRS should be willing to rule on whether the trust complies with the trust rules, as it did for a living taxpayer in PLR 2003-24018. However, the IRS stated in this PLR that it was "unable" to rule on the Applicable Distribution Period that would apply after the taxpayer's death until after the taxpayer had actually died.

The IRS certainly does not limit rulings to completed transactions; see, *e.g.*, PLR 2002-42044, in which a surviving spouse proposed (as co-trustee of the trust named as beneficiary of participant's IRA) to demand that the IRA be distributed to the trust, and then (as beneficiary of the trust) to withdraw the distribution from the trust and roll it over to her own plan. The IRS granted her requested rulings on these proposed transactions, even though these were just as "hypothetical" as the future death of the taxpayer in PLR 2003-24018.

In this chapter, PLRs are cited as “authority” for various propositions because of the lack of authoritative guidance. Of course, a PLR cannot be relied upon as authority by anyone other than the taxpayer who obtained it. Furthermore, the fact that the IRS approved a particular trust instrument in a PLR is not equivalent to an IRS endorsement of that form of trust. The firm that obtained the ruling should not attempt to sell the trust form to other taxpayers as, in effect, an IRS-approved prototype document.

However, a PLR can serve as “substantial authority” for a position taken on a tax return for purposes of avoiding a penalty. Reg. § 1.6662-4(d)(3)(iii). Also, a court might hold the IRS bound by a position that the IRS has taken consistently in numerous PLRs.

#### ***6.4.03 Should you use a separate trust for retirement benefits?***

Should a client’s retirement benefits be left to a separate trust that will hold no other assets? Or should the client’s benefits be left to the same trust as the client’s other assets, with that trust being modified to include special provisions that apply only to the retirement benefits?

Separate-trusters point to the many practical difficulties of having numerous special provisions that deal only with certain assets. For example, if there is a regular “family pot” trust for the decedent’s minor children, with a conduit provision grafted onto it requiring the trustee to immediately pass out retirement plan distributions (see Form 4.8, Appendix B, for an example), will the trustee have to trace dollars in and out of the trust bank account? How quickly must the distribution be passed on before it merges into the rest of the trust’s cash? Will the trustee, the client, or a later attorney amending the trust recognize and so preserve the intricate web of provisions governing the retirement benefits? But single-trusters pooh-pooh these difficulties as exaggerated or inapplicable, and remind us that separate trust treatment is impracticable for smaller retirement plans.

See also ¶ 6.4.05 (opening paragraph plus subsection (F)) for more discussion of when to have separate trusts versus one pooled trust (and related questions).

#### ***6.4.04 Planning choices: Trust for disabled beneficiary***

Here are the options (A–D) available for a trust that is to be named as beneficiary of a retirement plan and that is intended to provide for a disabled beneficiary, when qualifying for see-through trust status is an important goal (¶ 6.2.01). Which option is best depends on whether the beneficiary must qualify for need-based government benefit programs, and on the identity of the remainder beneficiary. If qualification for benefit programs is a goal, the donor should consult with an attorney who specializes in drafting this type of trust. If the participant has *already died* and left benefits *outright* to a disabled beneficiary, see “E.”

- A. Conduit trust.** Under a conduit trust (¶ 6.3.05), all of the MRDs, as well as any other distributions the trustee receives from the retirement plan, would have to be promptly distributed to (or applied for the benefit of) the beneficiary. If such distributions are passed out to the disabled beneficiary, they would be considered available income or assets to the beneficiary, thus (unless the distributions are very small) forfeiting eligibility for welfare

benefits. Thus, a conduit trust is normally not suitable to be named as beneficiary for a disabled individual if the goal is to avoid forfeiting eligibility for welfare-type disability benefits. If qualification for welfare benefits is not an issue (for example, because the family intends to provide for all of the beneficiary's care), a conduit trust could be suitable, especially if the donor wants the remainder interest to pass to charity.

Note: A conduit-type provision has been used in a form book for inclusion in a *self-settled* "special needs trust" (also called a "(d)(4)(A) trust"). See Begley, Thomas D., Jr., and Canellos, Angela E., *The Special Needs Trust Handbook* (Aspen Publishers/Wolters Kluwer, as of 2009), page 6-123. This ¶ 6.3.13(A) deals with trusts that are named as beneficiary of a deceased participant's retirement benefits, *not* with the self-settled special needs trust that is created by the disabled beneficiary (or on his behalf by a legal guardian). Self-settled trusts have quite different problems and rules; see "E," below.

To date there is no IRS ruling that would allow payments from a conduit trust to be made to a special needs trust for the benefit of a disabled beneficiary rather than directly to the beneficiary or his guardian or custodian; compare "D" below.

**B. Accumulation O/R-2-NLP Trust.** Under most forms of "supplemental needs" trusts (designed to benefit a disabled beneficiary without causing loss of the beneficiary's eligibility for need-based government programs), the trustee has discretion regarding whether to distribute trust funds to or for the benefit of the disabled individual, but is prohibited from distributing funds for expenses that are paid for by the government programs such as support and medical care. Such a trust would be considered an accumulation trust for MRD purposes, but would still qualify as a see-through *if* the trust passes outright at the disabled beneficiary's death to other now-living individuals, such as the disabled beneficiary's siblings. See ¶ 6.3.08.

If an O/R-2-NLP trust is used, a charity cannot be named as remainder beneficiary. The chosen remainder beneficiaries should be (as siblings typically are) individuals who are close in age to (or younger than) the disabled beneficiary. The countable trust beneficiaries will be the disabled person and the remainder beneficiary(ies); the life expectancy of the oldest member of this group will be the ADP. Thus, drafting this type of trust is "easy" if there are siblings (or other suitable individual remainder beneficiaries) who are (1) living at the participant's death and (2) younger than or close in age to the disabled beneficiary—but impossible if there are no such suitable younger or close-in-age individual remainder beneficiaries.

*Thanks to Attorney Stephen J. Silverberg, Roslyn Heights, NY, for the following point:*

If the trust is also a "qualified disability trust," there would be additional advantages. Net income from a qualified disability trust is considered "earned income" of the child-beneficiary for purposes of the "kiddy tax" (the rule that *unearned* income of children under a certain age is taxed at the child's parents' tax rate). § 1(g)(4)(C). This is a favorable contrast to the treatment of retirement benefits paid directly to a child-beneficiary, which are considered *unearned* income. Reg.

§ 1.1(i)-T, A-6, A-9. Also, a qualified disability trust gets an exemption of \$2,000 for federal income tax purposes (compared with the \$100/\$300 exemption applicable to other trusts), although this exemption is subject to a phaseout in case of income over \$100,000. See § 642(b)(2)(C) for the special exemption rule and the definition of qualified disability trust.

- C. Accumulation 100 percent grantor trust.** A trust that gives the beneficiary the unlimited right to withdraw all the trust property at any time would be treated as a 100 percent grantor trust (¶ 6.3.10). It could be a suitable way to provide for a mentally handicapped beneficiary who (1) does not need to qualify for need-based government benefits (because this type of trust would disqualify him) and (2) can exercise the right of withdrawal only through a legal guardian, especially if the guardian is also the trustee. For this type of beneficiary, this type of trust provides the benefits of a discretionary trust while (presumably; see ¶ 6.3.10) allowing the life expectancy of the handicapped beneficiary to be the ADP. It also allows distributions to be taxed at the beneficiary's tax rate. This approach can be particularly helpful if the beneficiary has no siblings or issue, where the only likely remainder beneficiaries are either much older individuals, the beneficiary's own estate, or charities.
- D. Charitable remainder trust with payments to special needs trust.** If the donor is charitably inclined, consider making the retirement benefits payable to a charitable remainder trust (CRT; see ¶ 7.5.04 of *Life and Death Planning for Retirement Benefits*) for the life benefit of the disabled beneficiary. The retirement benefits can be paid to the CRT free of income taxes, and the annuity or unitrust payments can be paid to a special needs trust for the disabled beneficiary rather than outright to him (as is normally required for CRTs) if various requirements are met, according to Rev. Rul. 2002-20, 2002-1 C.B. 794.
- E. If the participant has already died.** Options A–D above apply during the planning stage, while the participant is alive and is trying to choose the best type of trust to name as beneficiary. If the participant has *already died*, and left the benefits *outright* to a disabled beneficiary, and qualification for government benefits is a concern, the disabled beneficiary's guardian could seek to have the benefits transferred to a "(d)(4)(A)" trust for the disabled beneficiary, as was done in PLRs 2006-20025 and 2011-16005. In drafting such a trust, qualification as a see-through trust is NOT a concern. Because the benefits were left *outright* to an individual, the benefits have already qualified for the life expectancy payout; see-through trust status is a concern only when the *participant leaves benefits to a trust*, not when a beneficiary who has inherited benefits outright subsequently *transfers* such benefits to a trust.

#### 6.4.05 *Planning choices: Trusts for minors*

Here are the options available for a trust intended to provide for minor beneficiaries, when qualifying for see-through trust status is an important goal (¶ 6.2.01). In deciding which to use, consider the donor's objectives: Is the donor's main goal to be sure that the "stretch" payout method is available? Or is the money most likely to be spent during the beneficiaries' childhood, for their

education and care, rather than conserved for the beneficiaries' own retirement years? Also consider the value of the benefits and other assets: Are the benefits and nonbenefit assets each substantial enough to justify establishing separate trusts, one for the benefits and one for the other assets? Are the benefits substantial enough to justify establishing a separate trust for each minor beneficiary, or is the "family pot trust" approach better?

Naming a minor directly as beneficiary of a retirement plan is not recommended. This approach may cause the plan administrator not to release the benefits to anyone other than a legal guardian of the minor. In some states, subjecting property to legal guardianship is not only time consuming and expensive, it restricts how the money can be spent for the minor's benefit.

Here are ideas regarding different ways to leave retirement benefits for the benefit of minor beneficiaries:

- A. Conduit trust (or IRT).** A conduit trust may make sense for benefits that are not intended to be the primary support source for the minor beneficiaries, such as a grandparent's IRA left to grandchildren who are supported by their parents. Also consider a trustee IRA in this situation (¶ 6.1.07).

**Emily Example.** Aunt Emily believes that leaving her IRA to her young nephew is a fine way to provide him with a nest egg, but knows that, if she names him directly as beneficiary, he will simply cash out the account immediately upon her death. So she leaves the IRA to a conduit trust for him. ¶ 6.3.05. The purpose of the trust is to make sure her nephew takes advantage of the "life expectancy payout," whether he wants to or not, and to provide professional management for the undistributed portion of the IRA. The nephew's support and education are paid for by his wealthy parents. The trustee is instructed to withdraw from the IRA, each year, the MRD (based on the nephew's life expectancy) and distribute it to the nephew. Aunt Emily could also use an IRT in this situation.

Even though a conduit trust partly defeats the purpose of leaving money in trust for a young beneficiary, some practitioners opt for this because it is a safe harbor and because they expect that the MRDs that would have to be passed out to the minor beneficiary (or his guardian or custodian) would be very small because of his young age. A conduit provision "inside" another trust may also be a good way to leave benefits to minors if the retirement benefits are not substantial enough to justify establishing a separate trust. The benefits are left to the same trust as all the other assets, but that trust contains "conduit" provisions requiring the trustee to pass through all retirement plan distributions. See Form 4.8, Appendix B.

On the other hand, if the benefits are a significant part of a trust fund that will be providing the primary source of support and education for an orphaned family, a conduit trust may not be a good match. The trustee would be required to distribute to one or more of the children, each year, all distributions the trustee receives from the retirement plan. Even assuming the trustee can pick and choose, each year, which member of the group will receive that year's distributions, the trustee has no discretion to accumulate distributions for possible later needs. If later changes in the minimum distribution rules, or in the income tax laws, make accelerated distributions either mandatory or desirable (*e.g.*, because tax rates are about to go up substantially), the trustee cannot comply with (or take advantage of) the changed tax rules without losing control of the funds.

- B. Circle Trust: Last man standing.** If a conduit trust is not suitable, so an accumulation trust for the minors must be named as beneficiary, the problem becomes, who will receive the benefits if the minor dies while the trust is still in effect? That contingent remainder beneficiary “counts” as a beneficiary for purposes of the minimum distribution trust rules, and it can be difficult to figure who that remainder beneficiary should be. (The minor’s future unborn issue don’t count; see ¶ 6.3.08(B).)

If the trust is for the benefit of several minors, one solution is to provide that if, at any time, there is only one beneficiary of the trust who is still living, the trust terminates at that time and all assets are distributed outright to that one. Thus, the living person who will receive the benefits outright on the death of all other beneficiaries is one of the children who are intended to be the sole or primary beneficiaries of the trust. This is the “Circle Trust” approach (see ¶ 6.3.09). This approach makes it unnecessary to name some remainder beneficiary the donor doesn’t really want to name (see “C”). The drawback is that if the provision is triggered the benefits could pass outright to a very young individual (through his legal guardian or a custodian for his benefit). See Form 4.9, Appendix B.

- C. O/R-2-NLP: Who will be the “NLP” remainder beneficiary?** To avoid using a conduit trust, and still qualify as a see-through, practitioners look for ways to make the minors’ trust an O/R-2-NLP trust (¶ 6.3.08).

The typical minors’ trust calls for the trust to terminate and be distributed outright to the minors as each reaches a certain age (for example, age 35), or when all of the siblings have either reached that age or died. To be a see-through under the O/R-2-NLP approach it is necessary to have a younger individual remainder beneficiary who will inherit the benefits outright if all of the minor children die *before* reaching the stated age.

With a trust for an *adult* beneficiary, the outright remainder beneficiary can usually be the then-living issue of the primary beneficiary, but that approach will not work with minor children who have no issue at the time of the participant’s death. See ¶ 6.3.08(B).

Typically, the donor of a minors’ trust would name a “wipeout” beneficiary, to take the trust property if all of the minor children die without issue while there is still money in the trust. The problem is, if the wipeout beneficiary is a charity or other nonindividual, the trust will flunk Rule 5 (¶ 6.2.09); and if the wipeout beneficiary is an individual who is older than the oldest minor child, the wipeout beneficiary’s shorter life expectancy will be the ADP (¶ 6.2.07).

See PLR 2002-28025, which involved a trust for the benefit of two minors. The trust was to terminate and be distributed outright to the minors as each reached age 30, but if they both died before reaching that age, the trust would pass to other relatives, the oldest of whom was age 67 at the participant’s death. The IRS ruled that the 67-year-old’s life expectancy was the ADP because he was the “oldest trust beneficiary.” PLRs 2006-10026 and 2008-43042 (see ¶ 6.3.08(B)) are similar.

### **What the IRS Should do**

The IRS's position produces absurd results, as can be seen in these letter rulings. The IRS could easily eliminate this absurdity, and solve the headache of providing for minor beneficiaries, by adopting a simple convention as an add-on to the O/R-2-NLP concept. The IRS could make a rule that an individual will be considered an "unlimited" trust beneficiary (so successors to his interest can be disregarded as "mere potential successors") if his interest in the benefits is to pass to him outright either (1) immediately upon the death of the donor or of another beneficiary [as the rule already provides] *or* (2) upon the beneficiary's attainment of a certain age that is not older than age 45 (or age 35, or age 30, or whatever age the IRS prefers). By adopting that rule, the IRS would immediately make legal the most standard and normal trust provision for minor beneficiaries, which is that they will come into outright possession upon attaining a certain age—an age that (under the vast majority of trust instruments) they have an overwhelming likelihood of attaining, according to the IRS's own actuarial tables.

Here are some possible approaches for dealing with this problem. With each, a separate trust just for the retirement benefits may be required, since the remainder beneficiary provisions may be different for the benefits than for the other assets.

- ✓ One approach is for the donor to plug in the name of a younger individual as the wipeout beneficiary, perhaps a young niece, nephew, or other relative. The drawback of this approach, obviously, is that the donor ends up potentially leaving the retirement benefits to someone he is not really interested in benefitting.
- ✓ Another approach, used successfully in PLR 2002-35038, is to give the trustee the power to distribute the remainder to any individual beneficiary who was born in the same year as the donor's oldest child or in a later year (or give the minor children the power to appoint to any younger beneficiaries). Unfortunately, the IRS's rulings approving this approach are seriously defective, in that the rulings *fail to mention what would happen to the benefits if the power of appointment were not exercised*. Realistically, the trust instrument would still have to name a younger individual wipeout beneficiary to address this possibility.
- ✓ A third approach is to name, as the wipeout beneficiary, heirs at law who are younger than the oldest "real" beneficiary; see ¶ 6.4.08.

**D. Dump the stretch; buy life insurance.** Young parents of young children might consider drafting the trust to say exactly what they want it to say, ignoring the see-through trust requirements, and purchasing life insurance to assure adequate funds for payment of any extra income taxes caused by loss of see-through status. This may make more sense than accepting the drawbacks of approaches A–C.

**E. Staged distributions at various ages.** Trusts for minors often provide for a staged distribution of principal, *e.g.*, half at age 25, balance at age 30. Such staged distributions

create several headaches when the trust is beneficiary of a retirement plan. One is whether a retirement benefit is an asset of the trust that is capable of being valued and divided; while many practitioners assume the answer is “yes” with respect to an IRA (which is normally a mere custodial account holding easily-valued securities), the answer is less obvious for a nonassignable benefit under a traditional pension plan.

Another issue is whether the built-in income tax “debt” should be deducted in valuing the retirement benefits for purposes of determining the amount distributable to the beneficiary. A third is the hassle of dividing and transferring an inherited retirement plan; see ¶ 6.1.05. In view of these complications, consider not using such staged distribution for a trust that will hold retirement benefits.

**F. Whether to have a separate trust for each minor.** If the benefits are left to a typical “family pot” trust for the benefit of all of the donor’s children collectively, then (assuming the trust qualifies as a see-through) the ADP will be the life expectancy of the oldest child. The donor could leave the benefits to separate trusts, one for the benefit of each child, to enable each child’s trust to use that child’s life expectancy as the ADP.

The drawbacks of this approach are: the money is divided into rigid predetermined shares, without the ability of the trustee to distribute more money on behalf of a child who needs it more; and, unless the trusts are conduit trusts, you still have the problem of finding a younger remainder beneficiary if the child dies before reaching the age for outright distribution. If the trusts are not conduit trusts and remainder beneficiaries of each individual child’s separate trust are the other siblings, you are right back with the oldest child’s life expectancy being the ADP for all the trusts.

**G. Custodianship under UTMA.** Another choice (ideal where there are not enough assets to justify a trustee’s fee) is to leave the benefits to a custodian for the child under the Uniform Transfers to Minors Act (“UTMA”). § 3(a) of UTMA permits a “person having the right to designate the recipient of property transferable upon the occurrence of a future event” to nominate (“in a writing designating a beneficiary of contractual rights”) a custodian to hold such property under the Act on behalf of a minor beneficiary.

The main drawbacks of leaving benefits to a custodian under UTMA are that the beneficiary becomes entitled to the money outright at a certain age (typically 18 or 21, depending on state law), and that age may be younger than the age the parents would ideally like. Also, the benefits must be left to specific individuals (such as, typically, equal shares to the surviving children). You lose the flexibility of leaving benefits to a “family pot” trust where the trustee has discretion to spend more for one child than another depending on their needs.

The IRS has never ruled on the question of who is considered the Designated Beneficiary when benefits are paid to a custodian under UTMA. Presumably the IRS would recognize that the minor is the “beneficiary.” There would be no basis for the IRS to claim that the custodian is the beneficiary. Even though UTMA permits funds to be disbursed from a custodial account for the support of the minor (regardless of whether someone else is obligated to support that minor), the IRS

presumably would not claim that any person obligated to support the minor is somehow a co-beneficiary along with the minor.

The IRS recognizes that the minor is the sole owner of property held in custodianship when determining who is the “stockholder” for purposes of qualifying as an “S corporation” (Reg. § 1.1361-1(e)(1)), and presumably would do so also in the case of retirement benefits held by a custodian for a minor beneficiary. Income (including retirement plan distributions) paid to a custodian is taxable to the minor unless used to discharge someone else’s legal obligation to support that minor. Rev. Rul. 56-484, 1956-2 C.B. 23. If leaving benefits to a custodian for a minor, check applicable state law for format required, eligible custodians, and age at which the custodianship terminates.

#### 6.4.06 *Planning choices: Trust for spouse*

Here are options to consider for a trust intended to provide life income to the participant’s surviving spouse, including a credit shelter or QTIP trust, when qualifying for see-through trust status is an important goal (¶ 6.2.01). If the client is naming any type of trust for the spouse as beneficiary, be sure the client understands the income tax drawbacks of leaving benefits to a trust for the spouse as opposed to outright to the spouse. If qualifying for the marital deduction is important, see ¶ 3.3.02 (Appendix A). See also ¶ 7.5.06(C) of *Life and Death Planning for Retirement Benefits* regarding use of a charitable remainder trust for the spouse’s life benefit.

- A. Conduit trust as credit shelter or QTIP substitute.** If a retirement plan or IRA is left to a conduit trust of which the participant’s surviving spouse is the sole life beneficiary, the surviving spouse will be considered the “sole beneficiary” of the plan or IRA for purposes of the minimum distribution rules but not for purposes of the spousal rollover. See ¶ 1.6.06(A), Appendix A.

The primary *drawback* of a conduit-credit shelter trust is that, if the spouse lives long enough, MRDs will eventually cause most of the benefits to be distributed outright to her. Benefits distributed outright to the spouse will not “bypass” her estate and thus to that extent the trust will *not* save estate taxes. The new concept of “portability” of the federal estate tax exemption between spouses eliminates much of the need for naming “credit shelter trusts” as beneficiaries of retirement plans. For explanation of “portability” and other aspects of recent estate tax law changes, see the author’s *Special Report: Recent Developments 2013*, posted (free download) at [www.ataxplan.com](http://www.ataxplan.com).

Similarly, if the purpose of leaving benefits to a QTIP trust is to preserve the asset for the younger generation, a conduit trust will defeat that purpose, since most of the benefits will be distributed outright to the surviving spouse if she lives long enough. But a conduit trust for the spouse’s life may be fine if the participant just wants to make sure the spouse does not spend the entire fund at once.

### Conduit Trust Ironies

If the spouse is the conduit trust beneficiary, she is considered the “sole beneficiary,” so nothing needs to be distributed from the plan until the deceased participant would have reached age 70½. Thus, ironically, a conduit-credit shelter trust can be used to keep money *away from* the surviving spouse of a young decedent!

When MRDs do commence, the spouse’s life expectancy will be recalculated annually—meaning that she is guaranteed *not* to receive all of the benefits during her lifetime (if the trustee is limited to distributing to her only the MRD amount). Finally, a conduit trust for the life of the spouse, with remainder to a charity, “passes” the MRD trust rules (because the nonindividual remainder beneficiary is ignored), even though some of the benefits are *guaranteed* to pass to a nonindividual—which is the result the trust rules were supposed to prevent!

Here is another problem with using a conduit trust for the benefit of the surviving spouse: If the participant and the surviving spouse *both* die before the end of the year in which participant would have reached age 70½, the IRS will claim there is no “Designated Beneficiary” when the benefits pass to the remainder beneficiaries of the trust, even if the remainder beneficiaries are all individuals, causing the benefits to become subject to the 5-year rule on the death of the spouse. See § 401(a)(9)(B)(iv)(II) for the special rule that applies on the death of the surviving spouse-beneficiary when both spouses die young, and PLR 2006-44022, discussed at ¶ 1.6.05(C) of *Life and Death Planning for Retirement Benefits*. This drawback is not a factor if the participant has already passed his RBD, but since Roth IRAs have no RBD (see § 408A(c)(5)) it is a lifelong problem with respect to leaving a Roth IRA to a conduit trust for the participant’s surviving spouse.

Contrary to a popular belief, leaving benefits to a conduit trust for the spouse does *not* allow the Applicable Distribution Period to “flip” to the life expectancy of the children or other remainder beneficiaries at the spouse’s death; see ¶ 6.3.05(G).

**B. Accumulation O/R-2-NLP trust.** The typical QTIP or credit shelter trust is an accumulation trust (¶ 6.3.07), meaning that the remainder beneficiaries “count” for purposes of the all-beneficiaries-must-be-individuals rule and the oldest-beneficiary’s-life-expectancy-is-the-ADP rule. See, *e.g.*, PLR 9322005 (marital trust to a spouse for life, remainder to children; spouse *and children* regarded as beneficiaries).

If the trust is to terminate and pass immediately outright to the participant’s issue on the spouse’s death, the trust will “pass” the rules as an O/R-2-NLP trust *provided* that at least one issue of the participant survives the participant; if those conditions are met, the trust can provide whatever the participant wants it to provide regarding disposition of the trust assets if all the issue later predecease the spouse. ¶ 6.3.08. See Form 4.10, Appendix B. If using this format, it is advisable to name the issue *directly* as contingent beneficiaries of the retirement plan if the spouse does not survive the participant; see Form 3.4, Appendix B.

**C. Accumulation trust: Shares for issue held until certain ages.** If the trust does not pass immediately outright to the participant’s issue upon the surviving spouse’s death, but rather is to be held in trust for some or all of the issue until they reach certain ages, the trust will

not qualify as an O/R-2-NLP trust unless further steps are taken to assure that the benefits must pass outright to younger beneficiaries if all the issue die before reaching the specified ages. Having the trust “convert” at the spouse’s death to conduit trusts for the issue will NOT work; see ¶ 6.3.12(B).

Instead, consider providing that the trust terminates early and passes outright to the spouse if the spouse is the only survivor (¶ 6.3.09), and passes outright to the last surviving issue if, at any time after the spouse’s death, there is only one issue living (“last man standing”; ¶ 6.4.05(B)). Alternatively, name a younger individual as the outright “wipeout” beneficiary; see ¶ 6.3.08(B), ¶ 6.4.08.

#### 6.4.07 *Generation-skipping and “perpetual” trusts*

The MRD trust rules pose challenges for an estate planner who is trying to either avoid the generation-skipping transfer (GST) tax or take advantage of the GST exemption. See § 2601–§ 2664. A client may have the erroneous idea that a trust named as IRA beneficiary can somehow “stretch out” the IRA distributions perpetually over the ever-longer life expectancies of succeeding generations. Actually it is not possible to do that. See ¶ 6.3.05(G).

- A. Perpetual trusts; GST-exempt shares.** Leaving retirement benefits to a generation-skipping trust is usually not considered advisable because part of the GST exemption will be “wasted” paying income taxes. However, it can be appropriate for a Roth plan (“qualified” distributions from which are not subject to income tax; § 408A(d)(1)), or for a traditional plan if the client has no other assets suitable for a generation-skipping gift.

Leaving the benefits directly to grandchildren outright, or to conduit trusts for the benefit of “skip persons,” poses no particular problems. If benefits are left to an “accumulation trust” (¶ 6.3.07) for the benefit of the participant’s descendants, the problem from the point of view of “passing” the MRD trust rules is to name an individual beneficiary who will receive the trust assets immediately, outright, on the death of all prior beneficiaries. One way to accomplish this is to use the “last man standing” approach so that, if at some time in the future there is only one issue of the participant living, the trust terminates and is distributed to that one individual at that time; see ¶ 6.3.09. The other is to provide that, if *all* of the participant’s issue die while there is still money in the trust, the trust will pass to the persons who would have been the participant’s heirs at law who are younger than the oldest trust beneficiary; see ¶ 6.3.17.

*Question 1:* As long as minimum distributions are made over the life expectancy of a specified trust beneficiary, why does the IRS care who actually gets the benefits?

*Answer:* Because the Code specifies that the distribution period is the life expectancy “of the beneficiary” of the benefits—not “of some randomly selected individual.” That is why the IRS “cares”—they are required to carry out the law enacted by Congress.

*Question 2:* Why doesn't the IRS make it easier for my wealthy clients to leave their retirement benefits to a perpetual trust so they can defer income taxes on the benefits AND eliminate several generations' worth of estate taxes on this money?

*Answer:* The purpose of the tax incentives associated with retirement benefits is to help individuals save for their retirement. The idea presumably was that plan participants would spend all or most of this money in their old age. The real question is why does the Tax Code allow *any* deferral of distributions beyond the death of the participant?

**B. Leaving benefits to a “GST-nonexempt” share.** A common estate planning technique for larger estates is for a parent to leave the amount of his GST exemption to a generation-skipping trust, and the rest of his estate to “GST-nonexempt” trusts for his children. Since leaving taxable retirement benefits to the GST-exempt trust wastes GST exemption (see “A”), it is usually considered preferable to leave the benefits to the GST-nonexempt shares.

If the benefits are left outright to the children, or to GST-nonexempt trusts that are conduit trusts for the children (§ 6.3.05), there is no problem—the children are recognized as the Designated Beneficiaries. If the benefits are left to an accumulation trust there can be a problem: The GST-nonexempt trust is by definition not sheltered by the parent's GST exemption. Therefore to avoid having a GST tax imposed on the trust at the child's death (when the trust passes to the child's issue, who are grandchildren of the original donor) it is common practice to give the child a general power of appointment by will over the GST-nonexempt share. This causes the child to be treated as the “transferor” of the GST-nonexempt share for GST tax purposes, so there is no generation-skipping transfer when the share passes to the child's issue at the child's death.

However, a general power of appointment at death requires that the child have the ability to appoint the trust to the child's estate, which is a nonindividual. § 2041(b)(1); see § 6.2.00. Thus, *if the child has a general power of appointment at death the nonexempt share trust will flunk the MRD trust rules, unless it is a conduit trust.*

Another solution is to give the child the right to withdraw all of the trust principal during his life with the consent of a trustee who does not have a substantial interest adverse to the child's exercise of such power, *instead of* giving the child a general power of appointment at death. This causes the trust to be included in the child's estate under § 2041(a)(2), (b)(1)(C), making the child the transferor for GST tax purposes, without causing the trust to have a nonindividual beneficiary. However, this type of withdrawal power would NOT make the trust a grantor trust under § 678, so the remainder provisions of the trust would still have to comply with the MRD trust rules, just as was true for the GST-exempt share (see “A”).

#### 6.4.08 “Younger heirs at law” as “wipeout” beneficiary

Some practitioners use, as the ultimate or “wipeout” beneficiary of a trust, the “heirs at law” of the participant (or of a particular beneficiary) who are living at the applicable time, with a proviso that any “heir at law” who is older than the oldest trust beneficiary (determined without regard to the wipeout provision) shall be deemed to have died prior to the applicable date.

There is no PLR to date specifically “blessing” this approach. It appears, based on such PLRs as 2006-10026 and -10027 and 2008-43042 (see ¶ 6.3.08(B)), that the IRS would “test” it by determining who would take if all the *other* trust beneficiaries died immediately after the participant, thus activating the provision; and that the provision would “work” *if* there is some identifiable living individual who would take under the provision at the time of the participant’s death.

One problem with this approach is that there may not be any such younger heir-at-law apparent in existence at the time of the participant’s death. If the applicable state intestacy law does not carry out individual heirship beyond a certain degree of kinship, and there is no younger heir at law-apparent living at the time of the participant’s death, then the trust’s wipeout provision would fail if all the “real” trust beneficiaries were to die immediately after the participant. (Remember, we don’t care how unlikely it is that the wipeout provision will actually be activated; for purposes of testing an accumulation trust, we have to pretend that it *is* activated immediately after the participant’s death.) The result of such a “failure” of the wipeout clause could be either that the contingent remainder would be deemed to be owned by the participant’s estate (a disastrous result under the minimum distribution rules) or that the hypothetical contingent remainder would pass directly to the participant’s “true” heirs at law (who might be either older individuals or the state).

This type of provision requires careful drafting. The drafter needs to specify: heirs regarding *which type of property* (some states’ laws have different heirship rules for real and personal property); *whose* heirs (the participant’s? a particular beneficiary’s?); the proportions in which they take (presumably the same as would apply under the applicable state law); the date as of which the determination of heirship is made; how to describe the beneficiary who is to be the “oldest,” so that heirs at law older than that beneficiary are deemed to have predeceased; and which state’s law applies.

#### ***6.4.09 How to Analyze (and Clean Up) a See-Through Trust***

The following was previously published in the Leimberg Information Services Inc. (LISI) *Employee Benefits Newsletter* ([www.leimbergservices.com](http://www.leimbergservices.com)) as Newsletter #593 (1/31/12), “How to Analyze (and Clean Up) a See-Through Trust.”

PLR 2012-03033 provides an excellent illustration of the tortuous process of analyzing a typical estate planning family trust for compliance with the IRS’s minimum distribution trust rules, and also demonstrates smart post-death planning to get the desired result—a “see-through trust.”

A “see-through trust” named as beneficiary of a retirement plan can use the “life expectancy of the beneficiary” payout method (based on the life expectancy of the oldest trust beneficiary) to achieve maximum potential deferral of distributions from the inherited plan. A trust that “flunks” the IRS’s minimum distribution trust rules, on the other hand, and so is not a “see-through trust,” typically is forced to withdraw benefits from the inherited retirement plan much more swiftly, resulting in the loss of potentially valuable deferral.

This ruling reminds us that drafting a “see-through trust” to be named as beneficiary of retirement benefits requires complying with very precise and narrow requirements—requirements that most typical estate planning trusts will NOT meet.

*The facts*

The participant (“Decedent B”) had established “Trust T.” Upon his death, the trust was to be divided into three separate trusts, the “Marital Trust” (for the life benefit of his surviving spouse, “Spouse C”), and the “Primary” and “Exemption” Trusts for the benefit of his two children D and E (who were not the children of Spouse C but who were younger than Spouse C). Decedent B died leaving his qualified retirement plan to the Marital Trust as named beneficiary. This step was good planning—Decedent B did not leave the benefits in such a way that they would have to pass through the funding formula of his living trust, rather, he named the Marital Trust directly as beneficiary if Spouse C survived him.

*Ruling sought—and obtained*

The purpose of the ruling was to analyze the Marital Trust and see whether it qualified as a “see-through trust” for purposes of the minimum distribution rules. If it did qualify then the trust would be entitled to have the qualified plan benefits “rolled” by direct trustee-to-trustee transfer into an inherited IRA payable to the Marital Trust as beneficiary, and to withdraw the benefits from the IRA in instalments over the life expectancy of the beneficiary of the Marital. For details on the mechanics and requirements of such post-death “nonspouse beneficiary rollovers,” see ¶ 4.2.04 of *Life and Death Planning for Retirement Benefits*.

The ruling illustrates how the IRS tests whether a trust is a see-through. Though there are a couple of questionable points or errors in the IRS’s analysis, but the IRS ends up with a favorable verdict so no one is likely to complain.

*Passing the “easy” tests*

First the IRS makes sure the easy details are taken care of: The trust became irrevocable at Decedent B’s death, and the parties represented to the IRS that the trust was valid under state law and that a copy of the trust instrument was furnished to the plan administrator by “October 30” [actually, the deadline is October 31] of the year after the year of Decedent B’s death. See ¶ 6.2.03.

*The long slog: Testing for all individual “identifiable” beneficiaries*

Then the IRS starts “testing” the trust beneficiaries. The IRS’s goal is to make sure that all trust beneficiaries are individuals, and that the oldest one can be identified.

The IRS starts with the life beneficiary of the Marital Trust, Spouse C. She is considered a beneficiary because she is entitled to life income plus discretionary principal payments from the Marital Trust. However, she is not considered the “sole” beneficiary of the Marital Trust, because (the IRS recites) “Under the terms of Marital Trust M, the trustee is not obligated to distribute the entire minimum required distribution to Spouse C. Consequently, the remainder beneficiaries—the Exemption Trusts and the Primary Trusts—must also be considered.”

This statement is the first flaw in the IRS’s analysis. In order for Spouse C to be considered the sole beneficiary of the trust (and therefore of the decedent’s plan benefits), she would have to be

entitled to receive immediate distribution from the trust of not only “the entire minimum required distribution” but of *all amounts* distributed from Decedent B’s account in the plan to the trustee during her lifetime. See Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2, discussed at ¶ 6.3.05(A).

However, the IRS gets to the right result despite this slight misstatement—the remainder beneficiaries must also be counted, and tested to see whether they are all individuals and whether the oldest one can be identified. So the IRS moves on to testing the remainder beneficiaries of the Marital Trust. Upon Spouse C’s death, the property of the Marital Trust would be allocated to either the Primary or the Exemption Trusts for the two children (or both), based on a formula. So the IRS “tested” each child’s Primary Trust and each child’s Exemption Trust.

For more explanation of the “testing” discussed below, see the discussion of “Outright-to-now-living-persons” (O/R-2-NLP) trusts at ¶ 6.3.08.

### *Testing the “Exemption” Trusts*

The terms of each child’s Exemption Trust were identical. The Exemption Trusts were designed to soak up the older generation’s generation-skipping transfer (GST) tax exemptions. As such each child’s Exemption Trust was to be held in trust for the child for life.

Since the child was not entitled to immediate outright distribution of the entire Exemption Trust upon Spouse C’s death, it was necessary to “test” where the money would go at the child’s death. The IRS found that at death, the child would have a power of appointment over the remaining assets of his or her Exemption Trust, “exercisable only in favor of the lineal descendants of Decedent B. To the extent that Daughter D or Son E fails to exercise that power as of his or her death, the remaining trust property passes to that child’s lineal descendants, or, if there are none, to Decedent B’s lineal descendants.”

So, the Exemption Trusts would always circle back to the descendants of B, and the IRS gives the Exemption Trusts its blessing: “As a result, any potential beneficiaries of the Exemption Trusts will be natural persons [i.e., descendants of B]. In addition, because Daughter D is the oldest living lineal descendant of Decedent B, and is younger than Spouse C, no potential beneficiary could have a life expectancy longer than Spouse C.” The Exemption Trusts pass the test because all the potential remainder beneficiaries of the Exemption Trusts are *individuals* and all are *younger than the known oldest trust beneficiary*, i.e., Spouse C.

The critical finding is that there were (at the time of B’s death) living descendants of B who would take the money immediately outright under this clause. For example if Child D died, her share would pass outright to Child E. If Child E died his share would pass outright to Child D. We know from prior PLRs that it is not enough to say “outright to issue” if there are no issue—there must be at least one “issue” living at the time of the participant’s death who would take under the default “outright to issue” clause in order for such younger issue to be counted as beneficiaries. See ¶ 6.3.08(B). This particular trust did not have that problem, so the IRS reached the correct result on this point.

*Testing the Primary Trust for Daughter D*

The “Primary” trusts were to be distributed outright to each child half upon his/her attaining age 30 and the balance at age 35.

The IRS first states that “At the time of Decedent B’s death, Daughter D was 35 and *therefore sole beneficiary of her Primary Trust.*” In other words, because Daughter D was in effect entitled to immediate outright distribution upon spouse’s death of anything that came to Daughter D’s “Primary Trust,” she is considered the sole remainder beneficiary of the Marital Trust with respect to this portion of the benefits.

This statement is correct under the analysis of Example 1 of Reg. § 1.401(a)(9)-5, A-7(c)(3), contained in such prior PLRs as 2004-38044, 2005-22012, 2006-08032, and 2006-10026: We go down the “chain” of beneficiaries until we find the first person who gets the money IMMEDIATELY and OUTRIGHT upon the death of the prior beneficiary (or of the participant). Under the terms of the Marital Trust and Primary Trust, any benefits being held by and payable to the Marital Trust that are to pass upon Spouse C’s death to Daughter D’s “Primary Trust” would “pass” the trust rules. We are entitled to ignore the possibility that D might actually die BEFORE Spouse C; any contingent beneficiaries would who take in that case are considered “mere potential successors” and they don’t count.

*Testing the Primary Trust for Son E*

Things are not so easy for Son E’s Primary Trust. At the time of Decedent B’s death, Son E was over 30 but under 35. Thus he would not have the right to withdraw all of his Primary Trust immediately upon the death of Spouse C if she died immediately after Decedent B—he would only have the right to withdraw half. The IRS states that “Son E was therefore sole beneficiary to half of his Primary Trust, but had a testamentary power of appointment over the remainder.” This hurried wording by the IRS can be translated as follows: “Son E is therefore considered the sole beneficiary of half of his Primary Trust, but not of the other half. With respect to the other half, whoever would get that other half if Son E died before reaching age 35 is also considered a countable beneficiary of Son’s Primary Trust. Therefore we must test and see who that contingent remainder beneficiary is.”

This path is correct under the IRS’s approach to testing trusts. In my opinion, a contingent beneficiary who will get the money only if Son E dies before age 35 should be disregarded, because of the overwhelming actuarial likelihood that the son will live to age 35. However, the IRS does not agree with me on this, so let’s follow along with the IRS’s approach.

Under the IRS’s approach we must follow the retirement plan dollars down this road:

First we must assume that Spouse C (age 61 at Decedent B’s death), having survived Decedent B, later dies within five years (i.e., while Son E, who is already over age 30, is still under age 35). (What are the actuarial odds that a 61-year-old woman will die within the next five years?) So we must assume that some of the retirement benefits in the Marital Trust will pass to Son’s Primary Trust while he is still under age 35.

Next we must also assume that Son E, having survived Spouse C, also tragically dies, before reaching age 35. If Son E died before reaching age 35 his Primary Trust would pass to his lineal

descendants, but he didn't have any as of Decedent B's death, and we are not entitled to assume he will have some before reaching age 35, so then what happens? In that case, the half of his share of the Primary Trust that was still age-restricted becomes subject to a power of appointment. The IRS does not provide the entire list of potential appointees—only that “Under the terms of Trust T, Son E could exercise his power of appointment in favor of any entity other than himself, his estate, or the creditors of either, and, to the extent the GST tax would otherwise apply, his power of appointment expanded to include himself, his estate, and the creditors of both.” Presumably the power of appointment included the power to appoint to any *individual* as well as any “entity”; otherwise the rest of the ruling makes no sense.

This broad power of appointment was a problem: It gave Son E the power to appoint retirement benefits to “entities” (i.e., nonindividual beneficiaries) and also to individuals who were older than Spouse C. So, to make the trust qualify as a see-through, “Son E executed a partial release of his testamentary power of appointment over the remaining half of his Primary Trust by written instrument dated Date 9. The Service assumes for purposes of this ruling that the release met any applicable requirements under the law of State S. Pursuant to Son E's release, he *relinquished* his right to appoint at his death any portion of the income or principal of his Primary Trust to *any beneficiary who is not a natural person or who is born before Spouse C.*” Emphasis added. Thus, in effect, after Decedent B's death, Son E rewrote Decedent B's trust to limit his power of appointment only to individuals younger than Spouse C, and relinquished his power to appoint to nonindividuals.

Anything wrong with that? A couple of quibbles:

First, Son E's “release” was not a “qualified disclaimer” within the meaning of § 2518. A partial disclaimer is “qualified” only if it relinquishes an interest created by the decedent (or an undivided portion of such interest). When a beneficiary purports to carve out and disclaim certain powers, rights, or interests that were not “separately” created by the decedent, even if the action is valid under state law, it's a nonqualified disclaimer. See Reg. § 25.2518-2. The IRS has stated that *qualified* disclaimers will be given effect for income tax (and therefore minimum distribution) purposes (see GCM 39858), but has never given such a blanket blessing to nonqualified disclaimers or “releases.” Nevertheless the IRS “blesses” this one.

Why didn't Son E totally disclaim the power of appointment over his Primary Trust, so his disclaimer would be “qualified?” Presumably because he wanted to preserve the right to appoint his share to some particular individual, perhaps his spouse, in the unlikely event that both Spouse C and he died before he reached age 35.

Also, the IRS had announced via another recent private letter ruling that it would no longer recognize post-death trust amendments for minimum distribution purposes. See PLR 2010-21038, dealing with a post-death state court reformation of a trust intended to make the trust qualify as a see-through. But apparently that “no-post-death-amendments” rule does not apply to a “partial release” of a power of appointment.

Nevertheless, the IRS gave effect to Son E's partial release and ruled that: “As a result of this release, the class of potential beneficiaries as of September 30 of the year following Decedent B's death contained only individuals, and the beneficiary with the shortest life expectancy was identifiable. Therefore, with respect to the first ruling request, the beneficiaries of Marital Trust M

will be treated as ‘designated beneficiaries’ within the meaning of section 401(a)(9)(E) and section 1.401(a)(9)-4, Q&A-1 and 5, of the Regulations.”

One good thing about this ruling is that the IRS also takes into account what would have happened to the trust property if son had NOT exercised his power of appointment: “Son E had no children; therefore, if he failed to exercise his appointment power as of his death, the balance of his trust would pass to Daughter D, who would have a right to withdraw the entire principal.” So the IRS “dotted the i’s and crossed the t’s,” verifying that the age-restricted half of Son E’s Primary Trust would pass only to “younger individuals” *regardless* of whether son did or did not exercise his power of appointment (as modified by the partial release). In some prior PLRs the IRS has seemed to forget (when ruling on the minimum distribution effect of a power of appointment) to test what would happen if a power of appointment *was* not exercised. See, *e.g.*, PLR 2002-35038.

*Here’s what the ruling doesn’t mention...*

The ruling shows how complicated it is to test even a relatively simple family trust for “see-through trust” qualification. And there are several additional complications that the IRS didn’t mention—whether because it had concluded these didn’t apply or because the IRS just didn’t think of these issues we don’t know. Consider:

- ✓ Under some states’ laws and under some trust instruments, a power of appointment includes a power to appoint in further trust. An appointment in further trust would automatically make a trust not qualify as a see-through—unless the power were limited to trusts that were irrevocable as of Decedent B’s death and of which a copy had been given to the plan administrator by October 31 of the year after the year of Decedent B’s death. The ruling does not mention the possibility of appointment in further trust, so perhaps under this trust instrument and/or applicable state law Son E had no power to appoint in further trust.
- ✓ The IRS ignores the possibility that one of Decedent B’s children could, after Decedent B’s death, legally adopt someone who was older than Spouse C, thus potentially causing the retirement benefits to ultimately pass (under the “issue of Decedent B” provision) to someone older than Spouse C. That possibility in theory should make the trust “flunk” the minimum distribution trust rules, unless the trust instrument specifically provides that such adoptions are ignored in interpreting the word “issue.”
- ✓ Finally, many trust instruments have a “holdback” clause, so that money passing outright to “issue” is not in fact distributed to them if they are under a certain age but rather is held in trust until they reach that age. Other than the specific age requirements applicable to the two children under the terms of the Primary Trusts, the IRS does not mention any such clause in Decedent B’s trust. Was there no such clause? Or did counsel and/or the IRS just choose to ignore it?

### *Getting to the happy ending*

Even though this trust was not perfectly drafted under the minimum distribution rules, the family benefitted from a combination of factors that got them to a good tax result.

First, Decedent B had specified which trust share his IRA should be payable to. That eliminated some headaches; see Item #7 of the “Trust Drafting Checklist” at ¶ 6.1.01.

Second, by the time Decedent B died his Daughter D was already over the age of 35, and thus entitled to outright distribution of all of her “Primary Trust,” so there was a living beneficiary who would inherit the benefits “immediately outright” on the death of Spouse C or of Son E. That put see-through trust status within reach, with just a little tweaking.

Third, the survivors acted quickly and had Son E execute a “partial release” to eliminate the final potential “nonindividual” and “older individual” beneficiaries, so they had good post-mortem legal advice.

Does all this seem unduly complicated? It is!

## 6.5 Trust Income Taxes: DNI Meets IRD

This ¶ 6.5 deals with the income tax treatment of retirement benefits that are paid to a trust and includible in the trust’s gross income. Income taxation of retirement benefits paid to an *estate* is generally the same as the treatment described here for *trusts*. § 641.

Fiduciary income taxation is an extremely complex topic; for complete treatment of the subject see sources in the Bibliography. The purpose of this discussion is solely to explain how the trust income tax rules apply uniquely to retirement plan distributions.

The discussion here does not apply to a nontaxable distribution from a retirement plan; see ¶ 2.1.06 for a catalogue of no-tax and low-tax retirement plan distributions. For income tax considerations in connection with a trust’s distributions to charity, see Chapter 7.

This section deals extensively with **income in respect of a decedent (IRD)**. For definition and basic rules of IRD, see ¶ 4.6.03 (Appendix A).

### *6.5.01 Income tax on retirement benefits paid to a trust*

When retirement benefits are distributed after the participant’s death to a trust that is named as beneficiary of the plan, the distribution is includible in the trust’s gross income just as it would have been included in the gross income of an individual beneficiary; see Chapter 2.

Qualifying as a “see-through trust” under the minimum distribution rules (¶ 6.2.03) makes no difference to the trust’s income tax treatment. See-through trust status matters only for purposes of determining when the trust must take distribution of the benefits; it has no effect on the tax treatment of those distributions once they arrive in the trust’s bank account.

There are several differences between trust (fiduciary) income taxes and individual income taxes. On the bright side, the trust may be able to reduce its tax by passing the income out to the individual trust beneficiaries (¶ 6.5.02); and a trust is not subject to the reduction of itemized deductions under § 68 (¶ 6.5.04).

On the negative side, trusts are generally in a higher income tax bracket than human beneficiaries. A trust (unless its existence as a separate entity is ignored under the “grantor trust rules”; ¶ 6.3.10) or estate is a separate taxpayer and pays tax on its taxable income at the rate prescribed for trusts and estates. A trust or estate goes into the highest tax bracket (39.6%) for taxable income in excess of \$11,950 (2013 rates). For an individual, the top income tax bracket applies only to taxable income above \$400,000/\$450,000.

Thus, in all but the wealthiest families, income paid to a trust will be taxed at a higher rate than would apply to the individual family members, unless the high trust tax rates can be avoided or mitigated by one of the following means:

- ✓ **Pass income out to individual beneficiaries.** A trust is entitled to an income tax deduction for distributions it makes from the trust’s “distributable net income” (DNI) to *individual* trust beneficiaries, if various requirements are met. See ¶ 6.5.02.
- ✓ **Charitable deduction.** A trust is entitled to an income tax charitable deduction for certain distributions it makes to *charity*. § 642(c). See ¶ 7.4.03 of *Life and Death Planning for Retirement Benefits*.
- ✓ **Transfer the retirement plan to a beneficiary.** A trust can transfer the retirement benefits, intact, to the trust beneficiary. ¶ 6.1.05. Following such a transfer, distributions will be made directly to the former trust beneficiary and (in most cases) taxed directly to such former trust beneficiary. See ¶ 6.5.07–¶ 6.5.08.
- ✓ **Grantor trust rules.** If the individual trust beneficiary is a U.S. citizen or resident, and has the unlimited right to take the retirement benefits out of the trust, the trust is considered a “grantor trust” as to that beneficiary, and distributions from the retirement plan to the trust would be gross income of the beneficiary rather than of the trust. ¶ 6.3.10.
- ✓ **Use the IRD deduction.** If the participant’s estate was liable for federal estate taxes, the trust gets an income tax deduction for the estate taxes paid on the retirement benefits. See ¶ 6.5.04.

#### **6.5.02 Trust passes out taxable income as part of “DNI”**

A trust gets a unique deduction on its way from “gross income” to “taxable income”: The trust can deduct certain distributions it makes to the trust’s individual beneficiaries. § 651, § 661. These distributions are then includible in the beneficiaries’ gross income. § 652, § 662. The trust’s income tax deduction is limited to the amount of the trust’s **distributable net income** or **DNI**, so this is usually called the “**DNI deduction**.” § 651, § 661.

If the trust’s income resulting from retirement plan distributions can be passed out to the individual beneficiaries of the trust as part of DNI, the income tax burden is shifted to the individual beneficiaries, and overall income taxes will be lowered if those beneficiaries are in a lower tax

bracket than the trust. Unfortunately, the DNI deduction is not as simple as some practitioners might wish.

First the good news: Retirement plan distributions received by a trust, like other items of IRD, become part of the trust's DNI. See definition of DNI at § 643(a); Reg. § 1.663(c)-5, Examples 6 and 9; and CCA 2006-44016. Accordingly, distributions of such IRD are eligible for the DNI deduction when passed out to the trust beneficiary, and are includible in the beneficiary's income. § 661(a); § 662(a)(2); Reg. § 1.662(a)-3.

Even though IRD, like capital gain, is a form of gross income that is usually allocated to "principal" for trust accounting purposes (¶ 6.1.02), IRD is *not* subject to the special rules that limit a trustee's ability to pass out capital gain as part of DNI. IRD goes straight into DNI just as interest and other "ordinary income" items do. CCA 2006-44016. In contrast, capital gains are not included in DNI (and accordingly cannot be passed through to the trust beneficiary) unless various tests are met. Reg. § 1.643(a)-3(a), (b).

Now the bad news: The mere fact that a trustee receives a retirement plan distribution and later makes a distribution to a trust beneficiary does *not* automatically mean that the distribution to the beneficiary carries with it the gross income arising from the retirement plan distribution. The trust might still be liable for the income tax on the retirement plan distribution it received. The question is (in trust administration lingo) whether such distribution "carries out DNI."

Here are the six hurdles the trustee must clear in order for the trust's distribution of IRD to carry out the income tax burden to the trust beneficiary as part of DNI:

- A. **Trust must authorize the distribution.** The DNI deduction will not be available unless the beneficiary is entitled to receive the money; thus, obtaining this deduction requires attention at the trust drafting stage. See ¶ 6.5.03.
- B. **Income must be required to be, or must actually be, distributed, in year received.** The DNI deduction is available only for gross income that either is required to be distributed, or is actually distributed, to the individual beneficiary *in the same taxable year it is received by the trust* (or within 65 days after the end of such taxable year, if the trustee elects under § 663(b) to have such distribution treated as made during such taxable year). § 651(a), § 661(a). Thus, in the case of *discretionary* distributions, the trustee must take action prior to the deadline; if no one considers the problem until it is time to prepare the trust's tax return, it will be too late.
- C. **Allocation of DNI when separate share rule applies.** If there are two or more beneficiaries, and they have "substantially separate and independent shares," a distribution to one beneficiary will not carry out DNI that is allocated under the "separate share" rule to a different beneficiary. See ¶ 6.5.05–¶ 6.5.06 for how this rule applies to retirement benefits.
- D. **Transfer of the plan does not carry out DNI.** Though a distribution *from* a retirement plan *to* a trust is IRD, and becomes part of DNI, the retirement *plan* itself, which is a "right to receive IRD," is outside the normal DNI rules. Accordingly, transferring the *plan itself* to the beneficiary generally does not "carry out DNI." See ¶ 6.5.07–¶ 6.5.08.

- E. No DNI deduction for distribution to charity.** The trust generally does not get a DNI deduction for distributions to charity. § 651(a)(2), § 663(a)(2).
- F. No DNI deduction for certain pecuniary bequests.** Finally, the DNI deduction is not available for distributions in fulfillment of a bequest of a specific sum of money (“straight” pecuniary bequest) unless the governing instrument requires that such distribution is to be paid in more than three instalments (which would be unusual). § 663(a)(1), Reg. § 1.663(a)-1. Thus a trustee’s distribution in fulfillment of a typical pecuniary bequest such as “pay \$10,000 to my grandchild” will not “carry out DNI” to the grandchild.

A “formula” pecuniary bequest is *not* considered a bequest of a specific sum of money for this purpose, so a formula pecuniary bequest *can* “carry out DNI.” Reg. § 1.663(a)-1(b)(1). A “formula pecuniary bequest” does not mean any pecuniary amount determined by a formula; it means a bequest of a sum of money determined by a formula where the amount of the bequest cannot be determined as of the date of death. Many marital deduction bequests are of this type. See PLR 2002-10002 for an example of a formula pecuniary bequest to a credit shelter trust.

**Roddy Example:** Roddy dies leaving his \$10 million IRA to the Roddy Living Trust. The trust provides that, upon Roddy’s death, the trustee shall distribute \$3.5 million to the Credit Shelter Trust; this is a flat dollar amount (pecuniary) gift, not derived from any formula. The trustee is to distribute the balance of the trust property to Roddy’s surviving spouse. The combined federal and state income tax rate applicable to the trust is 45 percent. The trustee withdraws \$6,363,636 from the IRA, thus creating \$6,363,636 of gross income to the trust. The trustee distributes \$3.5 million to the credit shelter trust. This distribution does not “carry out DNI” because it is in fulfillment of a pecuniary bequest that is not payable in three or more instalments, so the trust gets no DNI deduction. The trustee then pays \$2,863,636 of income taxes on the IRA distribution. The credit shelter trust is now funded with \$3.5 million of after-tax money. The balance of the IRA (\$3,636,364) is transferred to Roddy’s widow (§ 6.1.05) in fulfillment of her residuary marital share.

**Soroya Example:** Soroya leaves her \$10 million IRA to the Soroya Living Trust. The trust provides that, upon Soroya’s death, the trustee shall distribute to the Bypass Trust the maximum amount that can be left to beneficiaries other than Soroya’s spouse or charity without incurring a federal estate tax, and shall distribute the balance of the trust property to Soroya’s surviving spouse. The combined federal and state income tax rate applicable to the trust is 45 percent. The dollar amount payable to the Bypass Trust under Soroya’s funding formula is \$3.5 million. The trustee of the Living Trust withdraws \$3,500,000 from the IRA and distributes it to the Bypass Trust (or divides the IRA into two separate IRAs, one worth \$3.5 million and one worth \$6.5 million and transfers the \$3.5 million inherited IRA to the Bypass Trust). Either way (according to CCA 2006-44020) the Living Trust has \$3.5 million of gross income. Either way the Living Trust gets a DNI deduction of \$3.5 million, so the Living Trust has no income taxes to pay. The Bypass Trust is now funded with \$3.5 million all of which is included in the Bypass Trust’s gross income as DNI. The balance of the IRA (\$6.5 million) is transferred by the Living Trust (§ 6.1.05) to Soroya’s widower in fulfillment of his residuary marital share.

### 6.5.03 *Trust must authorize the distribution*

The trustee can distribute to the beneficiary only what the trust authorizes the trustee to distribute. This is not an income tax rule; it is part of the law of trusts.

If the trust instrument requires the trustee to distribute to the individual trust beneficiary all retirement plan distributions received by the trust (whether such plan distributions are considered income or corpus for trust accounting purposes), the DNI resulting from the plan distributions would be carried out and taxable to the beneficiary. § 643(a), § 661(a), § 662(a)(2); Reg. § 1.662(a)-3.

The problem is that some trusts are drafted without thought of the income tax consequences of the retirement plan distributions. Trustees can find themselves in the unhappy situation of not being able to pass out retirement plan distributions to the beneficiary because the trust instrument does not authorize it:

**Paul Example:** Paul leaves his IRA to a credit shelter trust that requires the trustee to pay all income of the trust to Paul's wife for life, and hold the principal in trust for distribution to Paul's issue upon his wife's death. The trustee receives a minimum required distribution (MRD) from the IRA. Under the state law applicable to Paul's trust, 10 percent of the MRD is allocated to trust income and the balance to principal; see ¶ 6.1.02(C). The trustee has no authority to distribute more than 10 percent of the MRD to Paul's wife; the other 90 percent must be retained in the trust, and will be taxed at trust income tax rates. Even if the trust says the trustee can distribute principal to Paul's wife "if her income is not sufficient for her support," the trustee cannot give her more than the 10-percent "income" amount unless she actually needs more for her support.

Accordingly, when drafting a trust that may receive retirement benefits, if you want the trust to take advantage of the DNI deduction to reduce income taxes on distributions from the retirement plan, the trust instrument must give the trustee discretion to distribute principal (or at least the part of principal that consists of distributions from retirement plans) to the individual beneficiaries. If you want the trust to be *forced* to take advantage of this deduction, see "conduit trusts" at ¶ 6.3.05.

### 6.5.04 *Trusts and the IRD deduction*

The recipient of inherited retirement benefits is entitled to an income tax deduction, called the "IRD deduction," for federal estate taxes paid on the benefits. For how to compute the deduction and when it may be taken, see § 691(c) and ¶ 4.6 of *Life and Death Planning for Retirement Benefits*.

If a retirement plan distribution to the trust is IRD when received, the trust is entitled to the applicable § 691(c) deduction, if any (see ¶ 4.6.04 of *Life and Death Planning for Retirement Benefits*), unless the IRD is passed out to the trust beneficiary(ies) in the same year it is received, as part of DNI, in which case the deduction also passes to the beneficiaries. Reg. § 1.691(c)-2. A different rule applies to charitable remainder trusts; see ¶ 7.5.05(C) of *Life and Death Planning for Retirement Benefits*. If the IRD is not passed out to the trust beneficiaries in DNI, then the IRD and the IRD deduction stay in the trust.

The deduction for federal estate taxes paid on IRD is an itemized deduction, subject to reduction (in certain years) under § 68. § 68 does not apply to trusts or estates, however, only

individuals. This creates an incentive for a participant whose estate will be subject to federal estate taxes to name a trust or estate as beneficiary of income-taxable benefits.

#### 6.5.05 *IRD and the separate share rule*

So far we have spoken of the trustee's receiving a retirement plan distribution, including it in the trust's gross income, then paying it out to the trust beneficiary and taking a DNI deduction. This simple pattern becomes more complex if the "separate share rule" of § 663(c) applies. Under this rule, "in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts."

When the separate share rule applies, if a fiduciary distributes money to a beneficiary, that distribution will carry out DNI only to the extent there is DNI that is properly allocable to that particular beneficiary's "separate share."

#### **Separate Accounts vs. Separate Shares**

The separate *share* rule of § 663(c) governs the allocation of DNI among multiple beneficiaries of a trust or estate. Do not confuse this rule with the separate *accounts* rule that dictates when multiple beneficiaries of a retirement plan are treated separately for purposes of the minimum distribution rules. See ¶ 6.3.02. These are completely different and unrelated rules!

The separate share regulations have the following special rule regarding the allocation of IRD that is "corpus" (principal) for trust accounting purposes: "(3) Income in respect of a decedent. This paragraph (b)(3) governs the allocation of the portion of gross income includible in distributable net income that is income in respect of a decedent within the meaning of section 691(a) and is not...[trust accounting income]. Such gross income is allocated *among the separate shares that could potentially be funded with these amounts...* based on the relative value of each share that could potentially be funded with such amounts." Reg. § 1.663(c)-2(b)(3). Emphasis added.

Here's how the separate share rule would apply to a retirement plan distribution that is corpus for trust accounting purposes:

**Jody Example:** Jody dies in Year 1, leaving his \$1 million 401(k) plan, \$1 million of real estate, and \$1 million of marketable securities to a trust. At Jody's death, the trust is to be divided into two equal shares, one for each of Jody's children Brad and Angelina, so each child is to receive a total of \$1.5 million. Each child's share is to be distributed outright to the child upon attaining age 35. Angelina is already age 36; Brad is 33. In Year 1, the 401(k) plan sends the trustee a check for the entire plan balance of \$1 million, creating \$1 million of gross income to the trust. The trustee immediately distributes the \$1 million it received from the 401(k) plan to Angelina in partial fulfillment of her 50 percent share. The trust has no other income, and makes no other distributions, in Year 1. What is the trust's DNI deduction for the distribution to Angelina?

**Step 1: Does the separate share rule apply?** The separate share rule applies here because distributions to Jody's children are made "in substantially the same manner as if separate trusts had been created" for them. Reg. § 1.663(c)-3(a). If this had been a "spray" trust, with the trustee having

discretion to pay income and/or principal of the entire fund to either child at any time (instead of having to give each child an equal amount) the separate share rule would not apply.

**Step 2: Is the plan distribution corpus?** The regulation next requires that we determine whether the 401(k) plan is “corpus” for trust accounting purposes. Assume that it is; see ¶ 6.1.02.

**Step 3: Does the trust instrument or state law dictate to which share(s) this plan distribution shall be allocated?** If either the trust instrument or state law mandates that the plan distribution be allocated to a particular share, that allocation will be followed for purposes of allocating the resulting DNI among the separate shares. To carry out Step 3, therefore, we must look at the terms of Jody’s particular trust and/or state law:

Scenario 1: If Jody’s trust *required* the trustee to allocate the 401(k) plan proceeds to Angelina’s share, then all the income arising from that plan distribution is allocated to Angelina’s “separate share” and the \$1 million cash distribution from the trust carries out \$1 million of DNI to Angelina. Reg. § 1.663(c)-5, Example 9.

#### **Allocation Respected Despite No Economic Effect**

Under the regulation, a trust instrument’s allocation of an IRD-corporus item to a particular beneficiary’s share is given effect for income tax purposes even if such allocation has no independent economic effect (i.e., it does not change the *amount* each beneficiary receives, it affects only the *taxability* of what each beneficiary receives). In other contexts, the regulations give effect to the allocation of a particular class of income to one beneficiary or another “only to the extent that it has an economic effect independent of the income tax consequences of the allocation.” See Regs. § 1.652(b)-2(b) and § 1.643(a)-5(b).

Scenario 2: Alternatively, if Jody’s trust requires that each beneficiary receive an equal share of each asset; or if the trust is silent on that topic but applicable state law requires such pro rata funding of the beneficiaries’ shares; the separate share rule will require that the DNI resulting from the retirement plan distribution be allocated equally to Brad’s and Angelina’s shares.

Thus, under Scenario 2, even though the trust distributed \$1 million to Angelina, the trust’s income tax deduction is only \$500,000, and Angelina includes only that much in her gross income for Year 1. The trust will have taxable income of \$500,000 for Year 1. This is the fair result the separate share rule was designed to bring about: Under a trust where the beneficiaries “own” fractional shares, no one beneficiary bears a disproportionate share of income tax just because he happened to receive more distributions in a particular year.

#### **6.5.06 IRD, separate shares, and discretionary funding**

Scenario 3: Continuing the Jody Example from ¶ 6.5.05, suppose Jody’s trust provides that “The Trustee shall not be obligated to allocate each asset equally to the two shares, but rather may allocate different assets to each child’s share, provided that the total amount allocated to each child’s share is equal.” The trust thus authorizes discretionary pick-and-choose (non-pro rata) funding.

The trustee has exercised its authority to choose which assets to use to fund each beneficiary's share: The trustee, in proper exercise of its discretion, allocated the entire \$1 million 401(k) plan distribution to Angelina's share. Does this enable the trustee to deduct the entire distribution as DNI?

Probably not. Though other interpretations are possible, the usual interpretation of the regulation is that, since the trustee *could* have elected to fund either beneficiary's share of the trust with the IRD, the trustee *must* (in computing its taxable income and DNI) allocate the IRD equally to the two shares. Under this interpretation, discretionary pick-and-choose funding generally produces the same result as mandatory pro rata funding (see exceptions below).

If the trustee of a trust that (1) is subject to the separate share rule and (2) permits discretionary pick-and-choose funding wants the gross income arising from a retirement plan to be allocated disproportionately, there are two ways to avoid the separate share rule and its apparently-mandatory pro rata allocation of IRD-corporus, assuming these techniques can be used consistent with the fiduciary's obligations to all trust beneficiaries:

- ✓ **Transfer the plan itself, rather than a distribution.** In the Jody Example, the trustee could transfer the 401(k) plan itself to Angelina, rather than withdrawing money from the plan and distributing the money to Angelina. See ¶ 6.1.05. Such a transfer generates no gross income at the trust level and accordingly the separate share rule for allocation of DNI never comes into play. The problem of Reg. § 1.663(c)-2(b)(3) is avoided. See ¶ 6.5.07.
- ✓ **Fund other shares first.** If the trustee wants to allocate a particular IRD-corporus item to one beneficiary's share, the trustee can distribute all the *other* assets first, fully funding all the other beneficiaries' shares before the year in which he withdraws funds from the plan. Then he is left with only one asset, the retirement plan, which he cashes out in the later year. This cash can only be used to fund one beneficiary's share (because all other beneficiaries have received their shares in full in previous years), so the distribution carries out all the DNI.

### 6.5.07 *Income tax effect of transferring plan*

See ¶ 6.1.05 regarding the ability of a trust or estate to transfer an inherited IRA or plan to the beneficiaries of the trust or estate. This ¶ 6.5.07 discusses the *income tax effects* of such a transfer to a specific or residuary legatee. For transfer in fulfillment of a pecuniary bequest, see ¶ 6.5.08.

The general rule is that the transfer of an inherited retirement plan "by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent" triggers immediate realization of the income represented by the retirement plan, because it is the transfer of a right to receive IRD. § 691(a)(2), first sentence.

However, this general rule does not apply to a "transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent." § 691(a)(2) (second sentence). Thus, when a retirement benefit is transferred out of an estate or trust to a beneficiary of the estate or trust, the transferring entity is not taxed on the transfer (for exception see ¶ 6.5.08). Instead, the transferee is taxable on the IRD as and when it is paid to such transferee. § 691(a)(1)(C); Reg. § 1.691(a)-4(b).

**Clothier Example:** Clothier’s IRA is payable to his estate. Clothier’s will leaves his personal effects, automobile, and IRA to his sister Wanda, and leaves the residue of the estate to his brother. Clothier’s executor transfers the personal effects, automobile, and IRA to Wanda. The transfer to Wanda is not a taxable event. Wanda withdraws money from the IRA. The withdrawal is taxable to Wanda as IRD. Reg. § 1.691(a)-4(b)(2).

The “person” to whom the right-to-receive-IRD is transferred could be a charity (see PLRs discussed at “B”), or a trust (see PLR 2008-26028), as long as the transferee is the beneficiary entitled to receive that asset under the decedent’s trust or from the decedent’s estate.

- A. Transfer from trust to trust beneficiary.** If the right-to-receive IRD is distributed as a specific bequest from a trust, or upon termination of the trust to a residuary legatee, the beneficiary who is entitled to the item, and not the trust, bears the income tax. Reg. § 1.691(a)-2(a)(3), (b), Example 1; § 1.691(a)-4(b)(2), (3). See PLRs 9537005 (Ruling 7), and 9537011.

What if the right-to-receive is transferred to a trust beneficiary under a discretionary power to distribute principal, but the trust is ongoing? Although the regulation refers to a “terminating” trust, the exception applies to any properly authorized transfer from the trust to its residuary beneficiaries, which is in effect a termination of the trust with respect to such asset. See PLRs 2005-26010, 2006-52028, 2008-03002, 2008-26028, and 2010-13033.

- B. Transfer from estate to estate beneficiary.** Similarly, the transfer of a retirement plan by an estate to the estate’s residuary beneficiaries is a nontaxable event. See PLR 2005-20004, in which the participant died leaving his IRAs and a 401(k) plan to his estate. The executor (who was authorized by the will to make distributions in kind) transferred the IRAs and plan to the estate’s residuary beneficiary, a charity, in partial satisfaction of the charity’s residuary bequest. This was ruled not to be an income-triggering assignment under § 691(a)(2); accordingly, only the charity realized gross income from the IRAs and plans (when later distributions were received by it). See also the similar PLRs 2002-34019, 2006-17020, and 2006-33009; 2006-18023 (nonqualified annuity transferred to residuary beneficiaries); 2008-50004; and 2008-50058.

Some rulings approving the transfer of an IRA from an estate to the estate beneficiaries as a nontaxable event do not mention § 691(a)(2): See PLRs 2004-52004, 2006-46025, 2006-46027, 2006-46028, 2006-47029, and 2006-47030.

#### **6.5.08 Funding pecuniary bequest with right-to-receive IRD**

¶ 6.5.07 dealt with the transfer of a retirement plan, intact, to a trust or estate beneficiary in fulfillment of a *specific or residuary* bequest. In Chief Counsel Advice (CCA) 2006-44020, the IRS addressed the tax consequences of a trustee’s transferring an IRA to a beneficiary to fulfill a *pecuniary* legacy. The Chief Counsel advised that the trustee’s assignment of an interest in an IRA

to a trust beneficiary in satisfaction of a pecuniary gift triggered realization of income at the trust level under § 691(a)(2). Citing *Kenan v. Comm'r*, 114 F. 2d 217 (2d Cir. 1940), the IRS said the trust “has received an immediate economic benefit by satisfying its pecuniary obligation to the Charities with property on which neither Trust nor Decedent have previously paid income tax which is a disposition for § 691(a)(2) purposes.”

Is the Chief Counsel correct? The *Kenan* case involved a fiduciary’s transfer of appreciated property (*not* IRD) in fulfillment of a pecuniary bequest, and dealt with § 663 (*not* § 691). In the author’s opinion, the second sentence of § 691(a)(2) should govern (and make the transfer nontaxable) when the right to receive IRD is transferred in fulfillment of a pecuniary bequest in (at least) the following two circumstances: Either the governing instrument requires that such bequest be fulfilled with that asset; or (even if the instrument does not explicitly require use of that asset) the fiduciary has no choice because no other asset is available:

**Ron Example:** Ron dies, leaving his \$1 million IRA payable to his trust as beneficiary. The trust contains a pecuniary formula marital bequest, under which the marital trust is entitled to \$400,000. The trust holds no other assets except the IRA. Ron’s trustee divides the IRA into two separate inherited IRAs, one with a value of \$400,000. The trustee transfers this \$400,000 IRA to the marital trust and keeps the other IRA for the residuary credit shelter trust. In this example, in the author’s opinion, the IRA is transferred to the marital trust “by bequest from the decedent.” The funding trust is not “selling” or “exchanging” the IRA; it is transferring the IRA to the person entitled to it under the terms of the decedent’s trust. The trustee has no choice regarding which asset to use to fund the marital trust—the IRA is the only asset available. Thus (in the author’s opinion) the transfer is not taxable under § 691(a)(2).

This conclusion is consistent with several PLRs in which the IRS allowed surviving spouses to roll over benefits that were paid to them through pecuniary bequests. See PLRs 9524020, 9608036, 9623056, and 9808043, all of which predate CCA 2006-44020; and 2009-40031 and 2009-43046 (issued *after* CCA 2006-44020). If the transfers of retirement benefits in those rulings had been treated as “sales,” the transfers would have triggered immediate realization (deemed distribution) of the underlying income, and there would have been nothing for the spouses to roll over. However, those PLRs did not discuss this issue or mention § 691(a)(2). In PLR 2006-08032, a trustee transferred shares of an IRA to charities in fulfillment of their pecuniary bequests; the IRS ruled that the transfers did not constitute distributions or rollovers under § 408, but did “not address the issue of whether” the trust realized income under § 691 by virtue of these transfers.

For planning purposes, it is wise to assume that the transfer of retirement benefits out of an estate or a trust to a beneficiary in fulfillment of a pecuniary bequest will trigger immediate realization of income under § 691(a)(2) and estate planners should draft their instruments in a way that will avoid the problem; see ¶ 6.1.01, #7.

## 6.6 See-Through Trust Tester Quiz

Use this quiz to test whether a particular trust qualifies as a see-through trust under the IRS's minimum distribution trust rules (§ 6.2–§ 6.3). The quiz is in two parts, PART I (Preliminaries) and PART II (Beneficiaries and substantive terms). PART III provides some answers to the quiz.

In some but not all cases, this quiz will give you “the answer” regarding whether a particular trust qualifies (in the author's opinion) as a see-through. In cases with no definite answer, the quiz will reference the section of this book that explains the issues involved.

### PART I: PRELIMINARIES

1. At the time it receives the retirement benefits, will the trust be valid under state law? See § 6.2.05.

Yes: Go to Question 2.

No: Go to Answer A.

2. Is the trust irrevocable, or will it become irrevocable upon the participant's death? See § 6.2.06.

Yes: Go to Question 3.

No: Go to Answer A.

3. Has a copy of the trust instrument (or alternative permitted documentation) been provided to the plan administrator no later than October 31 of the year after the year of the participant's death? See § 6.2.08(A).

Yes: Go to Question 4.

No: Go to Answer B.

4. Does the trust provide that retirement benefits payable to the trust may not be used to pay debts, expenses, or taxes of the participant's estate, or otherwise be paid to the participant's estate, after September 30 of the year after the year of the participant's death (or at all)? See § 6.2.10.

Yes: Go to PART II of the Quiz.

No: If the participant is living, amend the trust to include such a provision. If the participant is deceased, “fix” the trust using a cleanup strategy as described in § 6.2.10. Then proceed to PART II.

### PART II: BENEFICIARIES AND SUBSTANTIVE TERMS

Having dealt with the preliminaries, we now turn to testing the beneficiaries of the trust. In applying this quiz, remember that:

- ✓ The time to apply these questions is at the moment of the participant's death. If the participant is still alive, pretend that he dies right now; what would happen to the benefits that would flow into this trust if the participant died right now?

- ✓ Ignore any beneficiary who dies before the participant, even if he/she is named in the trust. See Example 3, below.
- ✓ The quiz may not work properly in case of “double deaths,” i.e., where a trust beneficiary survived the participant, but then died prior to complete distribution of his/her trust share. In such cases, see instead ¶ 4.4.12 of *Life and Death Planning for Retirement Benefits*.
- ✓ If the retirement benefits are payable directly to a particular separate trust, share, or subtrust created under the trust instrument as named beneficiary under the participant’s beneficiary designation form, apply these questions ONLY to that particular separate trust, share or subtrust. See ¶ 6.3.01(B). Otherwise, see the rest of ¶ 6.3.01 regarding whether to apply these questions to the entire trust.

Example 1: Janice’s IRA is payable to “the trust created for the benefit of my son Timmy under Article xxi of the Janice Trust.” Apply these questions to the separate trust that is to be created for the benefit of Timmy, *ignoring* the other trusts (if any) created under the Janice Trust. (Of course, if upon Timmy’s later death or some other event the assets in his separate trust will flow out to other shares created under Janice’s trust, you may end up having to test all the shares anyway.)

Example 2: Godfrey’s IRA is payable to the Godfrey Trust. On Godfrey’s death, the trust divides into a marital trust and a credit shelter trust. You need to test BOTH subtrusts, since the IRA is payable to the single “funding” trust. If (under the terms of the Godfrey Trust, or applicable state law, or as a result of applying a formula or the trustee’s discretion), the IRA ends up being allocated to only one or the other of the two subtrusts, see ¶ 6.3.01 regarding whether you can “ignore” beneficiaries of the other subtrust or share.

Example 3: Doris leaves her IRA to a trust that says “Pay income to my husband Corey for life, and on the death of the survivor of my husband and myself distribute the principal outright to my then-living children.” Corey predeceased Doris. Corey is NOT counted as a beneficiary of Doris’s trust. You start your trust testing with ONLY those trust beneficiaries (and potential trust beneficiaries) who are actually living at the participant’s death or may be born later.

5. Test for “conduit trust” status. See ¶ 6.3.05–¶ 6.3.06. Is there one individual beneficiary, or is there a group of individual beneficiaries, who is or are entitled to receive from the trust, directly, upon receipt of such amount by the trust, all amounts (net of applicable fees; see ¶ 6.3.05(D)) distributed from the retirement plan during that individual’s life (or so long as any member of the group is alive)?

Yes, there is one single individual beneficiary so entitled: Go to Answer C.

Yes, there is a group of individual beneficiaries so entitled: Go to Question 6.

No. Go to Question 7.

When you answer Question 5:

If there is (or may be) another beneficiary who is (or may be) entitled to receive part or all of such distributions, *but* such other beneficiary will have no further interest in the trust or in the benefits as of September 30 of the year after the year of the participant's death, ignore such other beneficiary; see ¶ 6.3.03(A)–(C). If such other beneficiary died, see ¶ 1.8.03(C) of *Life and Death Planning for Retirement Benefits*.

If the answer to Question 5 would be “yes” but for the fact that plan distributions may be paid “for the benefit of” (rather than “to”) the conduit beneficiary, see ¶ 6.3.05(C). If the answer to Question 5 would be “yes” but for the fact that the beneficiary merely has the right to demand payment of such plan distributions to himself, rather than such payment's being automatically distributed, see ¶ 6.3.12(A).

**Florence Example:** Florence's trust says “Following my death, the trustee shall withdraw the annual minimum required distribution (MRD) from my IRA each year, and promptly transmit such MRD to my son Beakie, and shall also pay to Beakie such additional amounts from the IRA or other trust assets as the trustee deems advisable.” This trust does not qualify as a conduit trust because the trustee is required to transmit to Beakie only MRDs, not ALL distribution the trustee receives from Florence's IRA. Answer NO to Question 5.

**Rhett Example:** Rhett's trust says “Following my death, the trustee shall pay \$10,000 to Charity X, no later than September 30 of the year after the year of my death; and the trustee shall withdraw the annual minimum required distribution (MRD) from my IRA each year, and such additional amounts as the trustee deems advisable, and shall promptly transmit such MRDs and additional amounts (if any) to my son Bip.” Ignore Charity X and Answer YES to Question 5.

6. We have established that there is a “conduit trust” for the benefit of more than one individual. Of the group of individual “conduit” beneficiaries, is it possible to identify, at the time of the participant's death, which member of the group has the shortest life expectancy? See ¶ 6.2.07.

Yes: Go to Answer D.

No: Go to Answer A.

7. We have established that the trust is not a “conduit” trust with respect to an individual beneficiary (or group of individuals), so the trust is an “accumulation” trust. We next test whether the trust qualifies as a see-through under one of the qualification methods available to accumulation trusts. Does one individual trust beneficiary have the absolute right to withdraw all assets from the trust at any time?

Yes: The trust qualifies as a grantor trust with respect to the individual beneficiary. See ¶ 6.3.10 regarding whether it qualifies as a see-through trust.

No: Go to Question 8.

8. Must the trust terminate immediately, and be distributed outright to one of the individual trust beneficiaries, if all *other* individuals who are beneficiaries of the trust die while there is still money in the trust?

Yes: This trust qualifies as a see-through trust because it is a “circle” or “last man standing” trust. See ¶ 6.3.09, ¶ 6.4.05(B).

No: Go to Question 9.

9. We have determined that the trust does not qualify as a see-through trust either as a conduit, 100 percent grantor, or circle (last man standing) trust. The final step is to test the trust beneficiaries to see whether the trust qualifies as an “O/R-2-NLP” trust, and if so who the oldest (countable) beneficiary is. See ¶ 6.3.08.

To answer Question 9, make a list of *all* beneficiaries of the trust who are or may be entitled to the benefits, in the order in which they are entitled. Go all the way down the chain of beneficiaries and potential future beneficiaries and contingent and even wipeout beneficiaries as far as you can go, UNTIL you come to a beneficiary who (or which) is entitled to *immediate outright* distribution of the benefits upon the death of a prior beneficiary. That “unlimited” beneficiary (to use the IRS’s term) is the last beneficiary you have to “count.”

If every beneficiary on your list is an individual, the trust qualifies as see-through trust, and the ADP is the life expectancy of the oldest individual on your list. If the list includes a nonindividual, go to Answer A. If the trust never terminates, or cannot possibly terminate during the life of any person who is living at the participant’s death, see ¶ 6.3.16.

**Example 1:** “The trustee shall pay income to my husband for life, and on his death the trust shall terminate and the principal shall be distributed to our issue then living by right of representation. If there are no issue of ours living at the death of the survivor of my husband and me, the principal shall be paid to Charity M.” There is no provision for holding back distributions to a young or disabled beneficiary. At the time of the participant’s death, her husband survives her and they have at least one issue living. The beneficiary list contains husband and the then-living issue of participant and husband (excluding issue of then-living issue). All the beneficiaries are individuals, and the ADP is the life expectancy of the husband, because he is the oldest member of the group. Note that his life expectancy continues to be the ADP for the trust *even after his death*, because he was the oldest trust beneficiary in the moment after the participant’s death. However, if husband did not survive the participant, then he is not counted as a trust beneficiary; the then-living issue would be the beneficiaries, and the ADP would be the oldest living issue’s life expectancy.

**Example 2:** Here are the trust terms: “Article 1: The trustee shall pay income to my husband for life, and on his death pay the principal to my issue then living by right of representation. Article 2: If any individual becomes entitled to a distribution under this instrument at a time when he is under the age of 25 years, such beneficiary’s share shall be held in trust for his benefit until he reaches age 25. Article 3: If such issue later dies before attaining such age, his share shall be distributed to his issue then living, if any, otherwise to the then-living issue of such beneficiary’s nearest ancestor who is descended from my parents and who has issue then living, by right of representation, subject to Article 2, or, if there are no issue of mine then living to Charity M.” At the time of the participant’s death, her husband survives her, she has at least one issue living, and all of her issue who would inherit the trust if husband died one minute after the participant are under the age of 25, so the

“holdback” provision would apply. Since we must assume (for purposes of testing) that all of the issue die immediately after husband, and while under age 25, Charity M “counts” as a beneficiary and the trust flunks. However, if at least one of the issue is over age 25 at the time of the participant’s death, then that over-age-25 issue becomes the first “unlimited” trust beneficiary (who would take if all other beneficiaries die immediately after the participant), and the trust passes.

**Example 3:** “The trustee shall pay income to my son for life, and on his death distribute the principal to my son’s issue then living, if any, or, if he has no issue then living, to Charity M.” At the time of the participant’s death, her son survives her but he is only 12 years old and he has no issue then living. The beneficiary list for purposes of Question 9 contains son and Charity M. Because Charity M is not an individual, the trust does not qualify as a see-through. Go to Answer A. A few years after the participant’s death, the participant’s son marries and eventually has four children and 10 grandchildren. Because that didn’t happen until after the participant’s death, these “unborn issue” were not countable beneficiaries when the trust was tested at the time of the participant’s death—even though they (and not Charity M) *actually* inherit the trust upon the son’s ultimate later death

**Example 4:** “The trustee shall pay income to my son for life, and on his death distribute the principal outright and immediately to my son’s issue then living, if any, or, if he has no issue then living, to my siblings then living in equal shares, or if none of my siblings is then living, to Charity M.” At the time of the participant’s death, her son survives her but the son (age 12) has no issue living at the time of the participant’s death. At least one of the participant’s siblings is living at her death. The beneficiary list for purposes of Question 9 contains the participant’s son and any sibling(s) of the participant living at the participant’s death. Because at least one sibling survives the participant, and the sibling(s) will receive the trust immediately and outright upon the son’s death, Charity M is ignored as a “mere potential successor” to the siblings. Accordingly, all trust beneficiaries are individuals and the trust qualifies as a see-through. The ADP is the life expectancy of the oldest member of the group consisting of the son and the participant’s siblings living at her death.

### PART III: ANSWERS

The “answers” to the quiz are found in different places. In some cases, when you answer a particular question in a particular way, the answer is given to you right then and there. In other cases, you are referred to another section of this book (because the answer is not necessarily clear). Finally, in some cases you are told to “Go to Answer A” (or B, C, or D). Here are Answers A, B, C, and D:

**Answer A:** This trust does not qualify as a see-through trust under the IRS’s minimum distribution trust regulations. For the effect of “flunking,” see ¶ 6.2.01. If the participant is still alive and qualification would be desirable, consider having the participant amend his trust so it qualifies. If the participant is deceased, consider disclaimers, reformation, and other “cleanup strategies” discussed at ¶ 4.4–¶ 4.5 of *Life and Death Planning for Retirement Benefits*.

**Answer B:** This trust has not complied with the documentation requirement (¶ 6.2.08). If the participant is still alive, or he is dead but the filing deadline has not yet passed, comply with the requirement then answer Question 3 “yes” and proceed with the rest of the quiz. If the participant is dead and the filing deadline has passed, go to Answer A.

**Answer C:** This trust qualifies as a see-through trust for a single individual beneficiary (the “conduit beneficiary”) within the meaning of Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2.

**Answer D:** This trust should qualify as a conduit trust for the benefit of the multiple individual conduit beneficiaries, subject to caveats in ¶ 6.3.06.

## Appendix A: Selected Sections from Other Chapters of *Life and Death Planning for Retirement Benefits*

### *1.6.06 When is a trust for the spouse the same as the spouse?*

A trust for the spouse’s sole or primary benefit may be entitled to some of the special privileges that apply when the spouse individually is named as beneficiary:

- A. Spouse is sole beneficiary: conduit trust.** If the surviving spouse is the sole life beneficiary of a conduit trust that is named as sole beneficiary of the benefits, then she is considered the sole beneficiary of the participant’s account for purposes of the special spousal minimum distribution rules, namely: that distributions do not need to begin until the later of the year after the year of the decedent’s death or the year in which the decedent would have reached at 70½; that the spouse’s life expectancy is recalculated annually for purposes of computing MRDs; and that if the spouse dies before the year the decedent would have reached at 70½ she is treated as the “participant” for purposes of computing distributions to whichever beneficiary comes after her. See § 401(a)(9)(B)(iv) and ¶ 1.6.03(D)–(E), ¶ 1.6.04, and ¶ 1.6.05 of *Life and Death Planning for Retirement Benefits*. Reg. § 1.401(a)(9)-5, A-5(c)(2), A-7(c)(3), Example 2, paragraph (ii). See ¶ 6.3.05 for definition of “conduit trust.”

However, for purposes of the spouse’s right to elect to treat an inherited IRA as her own IRA (see ¶ 3.2.03 of *Life and Death Planning for Retirement Benefits*), the spouse must be the sole beneficiary of the IRA and this requirement is not satisfied “[i]f a trust is named as beneficiary of the IRA...even if the spouse is the sole beneficiary of the trust.” Reg. § 1.408-8, A-5(a). Thus a trust for the spouse’s benefit (even a conduit trust) *cannot* exercise the spousal election or rollover rights that a spouse named individually as beneficiary can exercise. For the spouse’s ability, in some cases, to use a rollover “through” the trust to achieve the same result, see ¶ 3.2.09 of *Life and Death Planning for Retirement Benefits*.

- B. Spouse is sole beneficiary: grantor trust.** If a trust is the sole beneficiary of the account, and the surviving spouse is treated as the owner of all of such trust’s property under the “grantor trust rules” (¶ 6.3.10), she *should* be considered the sole beneficiary of that trust and

accordingly should be considered the participant's "sole beneficiary" for purposes of the special spousal minimum distribution rules (though *not* for purposes of the spousal rollover and the spousal election to treat an inherited IRA as the spouse's own IRA). However, the regulations do not discuss grantor trusts and there are no rulings confirming that the grantor trust rules apply in this context.

- C. Typical QTIP-type trust: spouse is income beneficiary.** If the spouse does not have the right to demand distribution to herself of *either* (i) the entire amount of the participant's retirement benefits payable to the trust (as under a 100% grantor trust; see "B"), *or* (ii) whatever amounts are distributed from the retirement plan to the trust during her lifetime (as under a conduit trust; see "A"), the trust is not entitled to *any* of the privileges of the spouse. A typical example is a QTIP trust, under which the spouse is entitled only to "income" for life (with or without limited rights to principal). Many "credit shelter trusts" also fit this model.

Even if such a trust qualifies as a see-through trust (§ 6.2.03), and the spouse's life expectancy is the ADP (because she is the oldest beneficiary of the trust), "some amounts distributed from...[the retirement plan] to [the trust] may be accumulated in [the trust] during [the spouse's] lifetime for the benefit of [the] remaindermen beneficiaries." Therefore the remainder beneficiaries "count" as beneficiaries of the trust, and *the spouse is not the sole beneficiary of the trust*. Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 1(iii). Thus, the delayed Required Commencement Date (and related rules) of § 401(a)(9)(B)(iv) do *not* apply to benefits payable to such a trust. The special method of computing the spouse's life expectancy does *not* apply; the life expectancy of the oldest trust beneficiary is calculated on a fixed-term basis. Rev. Rul. 2006-26, 2006-22 I.R.B. 939.

#### 4.6.03 Tax on transfer of the right-to-receive IRD

**Income in respect of a decedent (IRD)** is not defined in the Code. The IRS defines it as "amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year..." Reg. § 1.691(a)-1(b).

Death benefits under qualified plans, 403(b) plans, and IRAs are IRD. Rev. Rul. 92-47, 1992-1 C.B. 198; Reg. § 1.663(c)-5, Example 9; PLR 9341008. IRD does not qualify for any "basis step-up" at the decedent's death.

Normally, IRD is includible (when received) in the gross income of the person or entity who acquired, from the decedent, the right to receive such income. § 691(a)(1). Although much less common than distributions, there is another event that can cause IRD to be taxable. If the person or entity who inherited the right-to-receive the IRD from the decedent transfers that right-to-receive-IRD to someone else, § 691(a)(2) provides that the IRD is immediately taxable, *to the transferor*. A distribution from a retirement plan is IRD; the retirement plan account *itself* is a right-to-receive IRD. (Even without § 691(a)(2), the transfer of a *retirement plan* by gift or pledge would normally be a taxable event anyway; see ¶ 2.1.04(C).)

Here are examples of how a transfer of the right-to-receive IRD could occur:

**A. Gift of right-to-receive IRD.**

**Stokely Example:** Stokely is named as beneficiary of his father’s IRA. After taking distributions for several years after his father’s death (and including such distributions in his income as IRD), Stokely decides he does not need this money and wants his sister to have it. He gives the inherited IRA to his sister. His gift is a transfer of the right-to-receive IRD, and the full value of the IRA becomes immediately taxable *to Stokely* under § 691(a)(2).

**B. Transfer from estate or trust to beneficiary.** Although the Stokely Example is unrealistic, there is one type of transfer of the right-to-receive IRD that is very common, and that is the transfer of an inherited retirement plan by an estate or trust to the individual beneficiary(ies) of the estate or trust. See ¶ 6.1.05. This type of transfer may or may not be taxable; see ¶ 6.5.07–¶ 6.5.08.

**C. Transfer to a 100 percent grantor trust.** Rev. Rul. 85-13, 1985-1 C.B. 184, established the principle that transactions between an individual and trust all of whose assets are deemed owned by such individual under the “grantor trust rules” (¶ 6.3.10) are not considered taxable transactions under the income tax Code, because “A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction.”

If a beneficiary transfers an inherited IRA to a trust of which he is considered the sole owner under § 678 (one of the “grantor trust rules”), the transfer, being a nonevent for income tax purposes, should not trigger deemed income under § 691(a)(2), *provided* that (under the terms of the transferee trust) the benefits cannot be distributed to anyone other than that beneficiary during his lifetime. Two PLRs confirm this conclusion. In PLR 2006-20025, an IRA that had been left to the participant’s disabled child outright as beneficiary was transferred to a “special needs trust” (“(d)(4)(A)” type, since the child was establishing it for his own benefit) established by the child’s guardian on his behalf, with probate court approval. In PLR 2008-26008, an IRA left outright to the participant’s minor child as beneficiary was transferred to a trust for the minor’s benefit established by the child’s guardian on his behalf, with probate court approval. In both cases the trusts were irrevocable. The IRS ruled the transfers were nontaxable.

**3.3.02 Leaving retirement benefits to a QTIP trust**

The most popular method of leaving retirement benefits to benefit the surviving spouse is leaving the benefits to her outright. The second most popular is to leave benefits to a “qualified terminable interest property” (QTIP) trust.

The “classic” QTIP trust provides for all income of the trust to be paid to the surviving spouse for her life, with the principal being paid to the donor’s issue on the spouse’s death. The spouse may or may not be given access to the principal of the trust during her life (such as through a standard based on health and support, or in the trustee’s discretion, or through a 5-and-5 power). The spouse may or may not be given a limited power to appoint the principal at her death.

Leaving retirement benefits to a QTIP trust is no tax bargain. Making benefits payable to a marital trust, as opposed to the spouse individually, often results in forced distribution of the benefits sooner (see “B”) than would be the case if the spouse personally were named as beneficiary. In addition to the loss of deferral, income-taxable retirement plan distributions to the trust (to the extent not passed out to the spouse as “distributable net income”; ¶ 6.5.02) are taxed to the trust. Trust income tax rates reach the top federal bracket at a much lower level of taxable income than individual rates do; ¶ 6.5.01.

If the client is determined not to leave any assets outright to his spouse, but is unhappy about the adverse MRD and income tax effects of a QTIP trust, consider making the benefits payable to the credit shelter trust, and using other assets to fund the marital trust. Although using this approach with income-taxable benefits is contrary to the usual rule of thumb (“don’t waste your credit shelter paying income taxes”), this move could substantially increase the potential deferral for the benefits *if* the spouse is not a beneficiary of the credit shelter trust and the beneficiaries of the credit shelter trust are much younger than the spouse, because MRDs will be spread out over a longer life expectancy period if the trust qualifies as a see-through (¶ 6.2.03).

- A. How a QTIP trust qualifies for the marital deduction.** Property qualifies for the estate tax marital deduction as QTIP if (1) the spouse is entitled for life to all of the income from the property payable at least annually, (2) no person has the power to appoint any of the property to someone other than the spouse during her lifetime, and (3) the decedent’s executor irrevocably elects, on the decedent’s estate tax return, to treat the property as QTIP. § 2056(b)(7). See ¶ 3.3.04 for how to determine the “income” the spouse is entitled to. See ¶ 3.3.03 for requirement of a separate QTIP election for the benefits.

Terminable interests are generally not eligible for the marital deduction, but § 2056(b)(7) allows the marital deduction for this type of trust, even though it definitely is a “terminable interest.” To assure the estate tax is merely deferred not eliminated, § 2044 provides that the surviving spouse’s estate includes any property for which the marital deduction was elected at the first spouse’s death.

- B. MRD effects.** If the trust qualifies as a see-through trust under the IRS’s minimum distribution trust rules, then the Applicable Distribution Period (ADP) for benefits payable to the trust can be based on the life expectancy of the oldest trust beneficiary. See ¶ 6.2. Note that, even if the trust qualifies as a see-through, distributing the benefits over the single life expectancy of the surviving spouse (as the oldest trust beneficiary) results in *substantially less deferral* than would be available if the spouse were named as outright beneficiary and rolled over the benefits to her own plan; see ¶ 3.2.01(A)–(C) of *Life and Death Planning for Retirement Benefits*.

### 3.3.03 IRS regards benefits, trust, as separate items of QTIP

Every estate planning lawyer should know how to draft a trust that complies with the marital deduction requirements. Many practitioners assume that, once the standard marital trust is drafted,

and the trust is named as beneficiary of the participant's retirement benefits, qualification of those benefits for the estate tax marital deduction is assured (assuming the spouse survives the participant and does not disclaim her interest in the marital trust).

The IRS has a different view. The IRS's position is that, when a retirement plan benefit is payable to a marital trust, both the retirement plan benefit *and* the trust must meet the marital deduction requirements. In the IRS's view, the retirement plan itself is an item of "terminable interest property" separate from the marital trust. Rev. Ruls. 2006-26, 2006-22 I.R.B. 939, and 2000-2, 2000-1 C.B. 305. This IRS position has two implications:

- A. What to do on the estate tax return.** Rev. Ruls. 2006-26 and 2000-2 require the executor, on the estate tax return (Form 706), to elect QTIP treatment for *both* the retirement benefit *and* the marital trust when retirement benefits are payable to a marital trust, confirming the approach seen in PLR 9442032 as well as Rev. Rul. 89-89, 1989-2 C.B. 231.
- B. How to draft the trust and beneficiary designation form.** The IRS does not require that all the marital deduction language must be recited in the beneficiary designation form as well as in the trust instrument. Although that would be one way to comply with the IRS's directive, Rev. Rul. 2000-2 says that the governing instrument requirements are satisfied with respect to a retirement benefit payable to a marital trust if (1) the marital trust document contains the required language (*e.g.*, giving the spouse the right to all the trust's *and the plan's* income annually) and (2) the retirement plan document does not contain any provisions which would prevent the trustee of the marital trust from complying with the trust's provisions with respect to the plan.

Accordingly it is advisable to specify in the trust instrument not only that the spouse is entitled to all income *of the trust* (which is the standard marital deduction trust language) but in addition to specify that the spouse is entitled to all income *of any retirement plan payable to the trust*. See Form 4.5, Appendix B. If dealing with a would-be marital deduction trust that does not contain this language, and the participant is already deceased, check to see whether the applicable state has enacted a statute automatically correcting this defect.

### ***3.3.04 Entitled to all income: State law vs. IRS***

One requirement a trust must meet if it is to qualify for the marital deduction is that the spouse must be "entitled for life to all of the income" of the trust.

The easiest way to comply with the entitled-to-all-income requirement is to require the trustee to withdraw from the retirement plan each year, and distribute to the spouse, the "income" of the retirement plan (as well as the income "of the trust"). Reg. § 20.2056(b)-5(f)(8). This method was "blessed" by the IRS in Rev. Rul. 89-89, 1989-2 C.B. 231, and Rev. Rul. 2006-26, and is believed to be the most commonly used by estate planners. See, *e.g.*, PLRs 9321035, 9321059, 9418026, and 9348025. For an example of a form using this method, see Form 4.5, Appendix B.

For other ways to meet the “entitled” portion of this requirement, see the *Natalie Choate Special Report: Retirement Benefits and the Marital Deduction (Including Planning for the Noncitizen Spouse)*, downloadable at [www.ataxplan.com](http://www.ataxplan.com).

¶ 6.1.02(D) explains how “income” must be determined, with respect to a retirement plan that is payable to the marital trust, in order to satisfy the marital deduction requirement that the spouse be entitled to the “income.”

A marital trust does not have to specify how “income” will be determined with respect to a retirement plan payable to the trust. If the spouse is entitled to the income of the retirement plan, then the trustee must determine that income in a manner that satisfies the IRS requirements, but the trust instrument does not have to spell out how that is done.

In Rev. Rul. 2006-26, the IRS ruled that the “10 percent rule” method of determining “income” with respect to a retirement plan (included in the widely adopted Uniform Principal and Income Act of 1997, “UPIA 1997”) does *not* satisfy the marital deduction requirement for income; see ¶ 6.1.02(C). Does this mean that every marital trust drafted prior to that ruling must be amended? No.

Any trust that contains the specific direction that the trustee must pay the surviving spouse *the income of any retirement plan payable to the trust* does not have to be amended to reflect Rev. Rul. 2006-26, for the following reason. Under the IRS’s logic, the “income of the retirement plan” means, as noted in ¶ 6.1.02, either the internal investment income of the account or an acceptable unitrust alternative. In the IRS’s view, the 10 percent rule dictates how the trustee is to allocate plan distributions in determining the income *of the trust*, but has nothing whatsoever to do with the income *of the plan*! Therefore if the instrument specifically requires the trustee to pay the spouse the income of the trust’s share of the plan, the trustee is required to pay her the internal income of the trust’s share of the plan (or unitrust amount, if applicable), *regardless* of whether the UPIA 1997 10 percent rule applies to the trust.

While this IRS interpretation probably makes a hash of the UPIA drafters’ intent (it seems clear they thought the “income of the plan” was 10 percent of the MRD), it is a blessing for estate planners, because it means that most marital trusts drafted since 1989 with retirement benefits in mind will *not* have to be amended due to Rev. Rul. 2006-26, despite the widespread adoption of UPIA 1997. The IRS view that the benefits and the trust itself constitute separate items of QTIP has been known since Rev. Rul. 89-89, 1989-2 C.B. 231, so many estate planners have long included the extra language specifying that the spouse must receive income “of the plan” as well as “of the trust.” For example, the requirement that the trustee pay the spouse the income of the plan, not merely of the trust, has been part of the sample forms in this book since its first edition (1996).

A marital trust that is named as beneficiary of a retirement plan, and which states that the surviving spouse is entitled to all income “of the trust,” but does *not* specifically state that the spouse is entitled to all income of the trust’s interest *in the retirement plan*, should be amended if applicable state law would not require income of the plan to be paid to the surviving spouse.

Trustees of existing marital trusts that hold inherited retirement benefits, where the participant has already died, do not have the option of amending the trust. If the trust does not contain its own IRS-acceptable definition of income with respect to retirement benefits, and does not contain the magic words that the spouse is entitled to the income of the plan, and is governed by the UPIA 1997 10 percent rule, the trustee faces a dilemma. Rev. Rul. 2006-26 indicates that such a trust

may not qualify for the marital deduction. However, if the federal estate tax return has been filed and accepted, with the marital deduction allowed, it's not clear what the IRS can do about it at this stage. Fixing this problem is beyond the scope of this book.

### ***3.3.07 Do not require stub income to be paid to spouse's estate!***

Suppose a marital deduction trust receives income throughout the year, collects it in a bank account, and then periodically distributes everything in the account to the surviving spouse—say, quarterly or annually. What happens if the surviving spouse dies after the trust has collected some income but before the trust has gotten around to distributing that income to her?

The trustee is NOT required to pay this “stub income” to the surviving spouse's estate as a condition of qualifying for the marital deduction. Reg. § 20.2056(b)-7(d)(4) specifically provides that “An income interest does not fail to constitute a qualifying income interest for life solely because income between the last distribution date and the date of the surviving spouse's death is not required to be distributed to the surviving spouse or to the estate of the surviving spouse.” Yet some trust-drafters, apparently under the mistaken impression that such a provision is required as a condition of qualifying for the marital deduction, include in their marital trusts a provision that such stub income must be paid to the estate of the surviving spouse. The result of including this provision is that the surviving spouse's estate (a nonindividual; ¶ 1.7.04) will be considered a countable beneficiary of the trust for minimum distribution purposes, causing the trust to “flunk” the IRS's minimum distribution trust rules (unless the trust is a conduit trust; see ¶ 6.3.05). See ¶ 6.2.09.

### ***3.3.08 Combination marital deduction-conduit trust***

A marital trust can also be a conduit trust. Under a conduit trust, the trustee must distribute to the conduit beneficiary (the surviving spouse in this case) ALL distributions the trustee receives from the retirement plan that is payable to the trust; see ¶ 6.3.05. There are two ways to draft a combination marital trust-conduit trust.

One method is to require the trustee to withdraw from the plan each year, and distribute to the spouse, the income of the trust's share of the retirement plan for such year or the MRD for such year, whichever is greater (and to distribute to the spouse any additional amounts the trustee withdraws from the plan). This combination is used by some practitioners who want a relatively simple structure that clearly qualifies for the marital deduction and as a see-through trust for minimum distribution purposes. See Form 4.7, Appendix B.

Another method which might be of interest if the participant has many years to go before he will reach age 70½ is to require the trustee to pass all plan distributions out to the spouse (as always is required under a conduit trust), but give the spouse only the right to *demand* income (¶ 3.3.05(B)) rather than requiring the trustee to automatically *distribute* all income regardless of demand. Since such a trust could defer the commencement of distributions until the participant would have reached age 70½ (¶ 1.6.06(A)), this approach could substantially extend the deferral of distributions compared with a standard QTIP trust. *All* plan distributions could be deferred until the year the participant would have reached age 70½. This approach makes a difference only if the participant died at a relatively young age.

## Appendix B: Selected Forms

### Why No Complete Trust Forms?

This Appendix contains sample clauses (from Appendix B of *Life and Death Planning for Retirement Benefits*) to carry out some of the recommendations in the text. Why do I supply only selected clauses and not an entire trust instrument? Trust forms vary widely from state to state and depending on the goals and purpose of the trust. It would require another whole book to supply complete trust forms; that is way beyond the purpose of this handout. This Appendix assumes you already have complete trust and will forms, and are looking for drafting samples of clauses related to the special problems of retirement benefits. For recommended sources of complete forms, see “RESOURCES, FORMS” in Appendix C.

### 3.4 Trust Is Beneficiary, but Only If Spouse Survives

See ¶ 6.1.01, #6.

#### II. Designation of Beneficiary

##### A. Primary Beneficiary

I hereby designate as my Primary Beneficiary, to receive 100% of the Death Benefit, if my spouse survives me, [TRUSTEE NAME], as Trustee of the [TRUST NAME] Trust, under agreement dated [TRUST DATE] [optional:; a copy of which is attached hereto].

##### B. Contingent Beneficiary

If my spouse does not survive me, I hereby designate as my Contingent Beneficiary, to receive 100% of the Death Benefit, my issue surviving me, by right of representation.

### 3.5 To Issue; Hold in Trust If below Certain Age

#### II. Designation of Beneficiary

I hereby designate as my Primary Beneficiary, to receive 100% of the Death Benefit, my issue surviving me, by right of representation; provided, however, that if any such Beneficiary is under the age of [AGE, such as “thirty”] years at the time of my death such Beneficiary’s share shall not be paid to such Beneficiary outright, but shall instead be paid to the trustee then serving as such under the separate trust to be established for such Beneficiary’s benefit under Article [NUMBER] of the [TRUST NAME] Trust, dated [TRUST DATE], a copy of which is attached hereto, to be held, administered, and distributed for the benefit of such Beneficiary as provided therein.

## 4. TRUST PROVISIONS DEALING WITH BENEFITS

See ¶ 6.4.01 regarding the “boilerplate” provisions (Forms 4.1–4.4) and why including these provisions in your trust agreement does NOT guarantee the trust’s qualification as a “see-through

trust.” Note: Some of the following Forms use defined terms (indicated by capitalized initial letters); if using those Forms, you would also need to use the applicable definitions from Form 4.11.

#### 4.1 Administration During Donor’s Life; Irrevocability

See ¶ 6.2.06. This form is not suitable for a testamentary trust.

##### \_\_\_ . Administration During my Life

.01 The trustee shall distribute to me such amounts of the principal or income of the trust (including all thereof) as I may request from time to time, or (if I am legally incapacitated) as my guardian, conservator, or other legal representative may request on my behalf.

.02 I reserve the right to amend or revoke this trust by one or more written and acknowledged instruments delivered to the trustee during my lifetime. This trust shall become irrevocable at my death.

#### 4.2 Forbidding Payment of Benefits to Nonindividuals

See ¶ 6.2.10 for why to forbid use of benefits to pay debts, expenses, and taxes of participant’s estate. See ¶ 6.3.01(D), ¶ 7.3.03, regarding why this form may not “work” with regard to other possible payments to nonindividual beneficiaries.

##### *Version A:*

Notwithstanding any other provision hereof, the trustee may not distribute to or for the benefit of my estate, any charity, or any other nonindividual beneficiary any Deferrable Retirement Benefit payable to this trust. It is my intent that all such Deferrable Retirement Benefits be distributed to or held for only individual beneficiaries, within the meaning of the Minimum Distribution Rules. Accordingly I direct that such benefits may not be used or applied for payment of my debts, taxes, expenses of administration, or other claims against my estate; nor for payment of estate, inheritance or similar transfer taxes due on account of my death. This paragraph shall not apply to any bequest or expense which is specifically directed to be funded with Deferrable Retirement Benefits by other provisions of this instrument.

##### *Version B:*

Notwithstanding any other provision hereof, the trustee may not, after September 30 of the calendar year following the calendar year in which my death occurs, or such earlier date as may be established under the Minimum Distribution Rules as the final date for determining whether this trust meets the requirements for treatment of the trust’s beneficiaries as if they had been named directly as beneficiary of any retirement plan payable to this trust (“Such Date”) for purposes of such Rules, distribute to or for the benefit of my estate, any charity, or any other nonindividual beneficiary any Deferrable Retirement Benefits payable to this trust. It is my intent that all such Deferrable Retirement Benefits held by or payable to this trust as of Such Date be distributed to or held for only individual beneficiaries, within the meaning of the Minimum Distribution Rules. Accordingly I

direct that such benefits may not be used or applied after Such Date for payment of my debts, taxes, expenses of administration, or other claims against my estate; nor for payment of estate, inheritance or similar transfer taxes due on account of my death. This paragraph shall not apply to any bequest or expense which is specifically directed to be funded with Deferrable Retirement Benefits by other provisions of this instrument.

#### **4.3 Excluding Older Adopted Issue**

See ¶ 6.2.07(A).

A person's "issue" shall not include an individual who is such person's issue by virtue of adoption if such individual was so adopted after my death and is older than the oldest individual who was a beneficiary of this trust at my death.

#### **4.4 Limitation on Powers of Appointment in Trust**

See ¶ 6.3.11(E) for why this clause may be needed.

Notwithstanding any other provision hereof, no Deferrable Retirement Benefit may be appointed, distributed, or transferred to any other trust unless (1) under the Minimum Distribution Rules, beneficiaries of such other trust are treated as having been designated directly as beneficiaries of such Deferrable Retirement Benefit for purposes of such Rules, and (2) the oldest beneficiary of such other trust was not born in a year earlier than the year of birth of the oldest beneficiary of this trust.

#### **4.5 Marital Deduction Saving Language**

See ¶ 3.3.03(B).

If this trust is or becomes the beneficiary of any Retirement Benefit, the trustee must withdraw from the trust's share of such Retirement Benefit, each year:

- A. So long as my spouse is living, the net income of the trust's share of such Retirement Benefit for such year; and
- B. Regardless of whether my spouse is then living, such amount or such additional amount (if any) as is required to be distributed from such share under the Minimum Distribution Rules (if applicable).

This paragraph shall not be deemed to limit the trustee's power and right to withdraw from the marital trust's share of the Retirement Benefit in any year more than the amount(s) stated above.

#### **4.6 Establishing a Conduit Trust for One Beneficiary**

See ¶ 6.3.05.

From and after my death, this trust shall be held for the benefit of [NAME OF INDIVIDUAL TRUST BENEFICIARY] (hereinafter referred to as the “Beneficiary”). Each year, beginning with the year of my death, my trustees shall withdraw from any Deferrable Retirement Benefit the Minimum Required Distribution for such Deferrable Retirement Benefit for such year, plus such additional amount or amounts as the trustee deems advisable in its discretion. All amounts so withdrawn (net of expenses properly charged thereto) shall be distributed to the Beneficiary, if the Beneficiary is then living. Upon the death of the Beneficiary (or upon my death if the Beneficiary does not survive me) all remaining property of this trust [here insert the provisions that will apply after the conduit beneficiary’s death; since the see-through trust rules “do not care” what these provisions say, they can be anything you want. Examples: “shall be paid to [NAME OF REMAINDER BENEFICIARY],” or “shall be held in further trust pursuant to the provisions of Article [NUMBER] of this trust instrument.”].

#### **4.7 Conduit Trust for Spouse (Marital Deduction)**

See ¶ 3.3.08.

From and after my death, this trust shall be held for the benefit of my spouse [NAME OF SPOUSE] (hereinafter referred to as “my spouse”), if my spouse survives me. Each year, beginning with the year of my death, and so long as my spouse is living, the trustee shall withdraw from any Retirement Benefit the income of such Benefit, or (in the case of any Deferrable Retirement Benefit) the Minimum Required Distribution for such Deferrable Retirement Benefit for such year if greater than the income of such Deferrable Retirement Benefit, plus such additional amount or amounts as the trustee deems advisable in its discretion. All amounts so withdrawn (net of expenses properly charged thereto) shall be paid directly to my spouse upon receipt by the trustee. Upon my spouse’s death (or upon my death if my spouse does not survive me) all remaining property of this trust [here insert the provisions that will apply after the conduit beneficiary’s death; since the see-through trust rules “do not care” what these provisions say, they can be anything you want. Examples: “shall be paid to [NAME OF REMAINDER BENEFICIARY],” or “shall be held in further trust pursuant to the provisions of Article [NUMBER] of this trust instrument.”].

#### **4.8 Conduit Provision Included in “Family Pot” Trust**

See ¶ 6.4.03. As a reminder, this approach works only for benefits that pass directly to this “Family Trust” upon the participant’s death under the participant’s beneficiary designation form. It will not work for a trust that is not established until the death of a prior beneficiary; see ¶ 6.3.12(B).

##### Administration of Family Trust

From and after my death, the trustee shall hold and administer all amounts then held by the trust, or that become payable to this trust as a result of my death, for the benefit of my children surviving me, upon the following terms.

- A. While there is any child of mine living who is under the age of [AGE, such as “thirty”] years, the trustee shall hold, administer, and distribute Deferrable Retirement Benefits as provided in Paragraph B and shall hold, administer, and distribute all other property of the trust as provided in Paragraph C.
- B. Each year, beginning with the year of my death, the trustee shall withdraw from any Deferrable Retirement Benefit the Minimum Required Distribution for such Deferrable Retirement Benefit for such year, plus such additional amount or amounts (if any) as the trustee deems advisable in its discretion. The trustee shall forthwith pay all amounts so withdrawn (net of expenses properly charged thereto) to such one or more of my children as are then living, and in such proportions among them, as the trustee deems advisable in its discretion.
- C. The trustee shall pay such amounts of the income and/or principal of property subject to this paragraph to (or apply it for the benefit of) such one or more of my children as are then living, and in such proportions among them as the trustee deems advisable in its discretion.
- D. At such time as there is no child of mine living who is under the age of [AGE, such as “thirty”] years, the trust shall terminate and be distributed outright and free of trust to my issue then living by right of representation, or, if there are no such issue then living, shall be distributed to [NAME OF DEFAULT REMAINDER BENEFICIARY].

#### 4.9 Last Man Standing Trust for Children

See ¶ 6.3.09 and ¶ 6.4.05(B).

##### \_\_\_\_. Administration of Family Trust

From and after my death, the trustee shall hold and administer all amounts then held by the trust, or that become payable to this trust as a result of my death, for the benefit of my children surviving me, upon the following terms. While there is any child of mine living who is under the age of [AGE, such as “thirty”] years, the trustee shall pay such amounts of the income and/or principal of the trust to (or apply it for the benefit of) such one or more individuals as the trustee shall select from the class consisting of all my issue then living, and in such proportions among them as the trustee deems advisable in its discretion for their care, support, education, comfort, and welfare. The trust shall terminate at the earlier of the following times:

- A. Such time as there is no child of mine living who is under the age specified above.
- B. Such time as there is only one child of mine living (regardless of such child’s age).

Upon termination, the trust property shall be distributed, outright and free of trusts, to my issue then living, by right of representation.

#### 4.10 “O/R-2-NLP” Trust (Spouse then Issue)

See ¶ 6.3.08. Note that the distribution to issue on the spouse’s death must NOT be contingent upon their having reached any particular age. This trust is not intended to qualify for the marital deduction.

Following my death, the trustee shall pay to or apply for the benefit of my spouse, as long as my spouse is living, all income of the trust and such amounts of the principal as the trustee deems advisable in its discretion for my spouse’s health and support in the standard of living to which my spouse had become accustomed during my life. Upon my spouse’s death (or upon my death, if my spouse does not survive me), the trust shall terminate, and all property of the trust shall be distributed, outright and free of trust, to my issue then living by right of representation.

#### 4.11 Definitions Used in Certain Trust Forms

This Form contains definitions that are used in Forms 4.2 and 4.4–4.8. Delete any definitions not used in the particular Form you are using.

##### \_\_\_. Certain Definitions

The following definitions shall apply in administering this Trust:

1. The **Code** means the Internal Revenue Code of 1986, as amended.
  
2. A **Retirement Benefit** means the trust’s interest in one of the following types of assets if payable to this trust as beneficiary or owned by this trust: a qualified or nonqualified annuity; a benefit under a qualified or nonqualified plan of deferred compensation; any account in or benefit payable under any pension, profit-sharing, stock bonus, or other qualified retirement plan; any individual retirement account or trust; and any and all benefits under any plan or arrangement that is established under § 408, § 408A, § 457, § 403, § 401, or similar provisions of the Code. **Retirement Benefits** means all of such interests collectively.
  
3. A **Deferrable Retirement Benefit** means any Retirement Benefit that meets the following two requirements: First, it is subject to the Minimum Distribution Rules. Second, a designated beneficiary of such Benefit has the option (either under the terms of the plan or arrangement that governs such Benefit, or by causing the Benefit to be transferred to an inherited IRA) to take distribution of such Benefit in annual instalments over the life expectancy of the (or of the oldest) designated beneficiary. **Deferrable Retirement Benefits** means all of such interests collectively. Benefits payable under a plan or arrangement that is not subject to the Minimum Distribution Rules (such as, under current law, a “nonqualified deferred compensation plan”) are not Deferrable Retirement Benefits.

4. The **Minimum Distribution Rules** mean the rules of § 401(a)(9) of the Code, including Regulations thereunder.

5. The **Minimum Required Distribution** for any year means, with respect to any Retirement Benefit: (1) the value of the Retirement Benefit determined as of the preceding year-end, divided by (2) the Applicable Distribution Period; or such greater or lesser amount as the trustee shall be required to withdraw under the laws then applicable to this Trust to avoid penalty. Notwithstanding the foregoing, the Minimum Required Distribution for the year of my death shall mean (1) the amount that was required to be distributed to me with respect to such Benefit during such year under the Minimum Distribution Rules, minus (2) amounts actually distributed to me with respect to such Benefit during such year. The terms “life expectancy,” “designated beneficiary,” and “Applicable Distribution Period” shall have the same meaning as under the Minimum Distribution Rules.

#### 5.4 Fiduciary Letter Transferring Plan Account to Beneficiary

See ¶ 6.1.05.

To the Plan Administrator of the [NAME OF RETIREMENT PLAN] (hereinafter “the Plan”):  
Re: Benefits of [NAME OF DECEASED PARTICIPANT], deceased (hereinafter “Participant”)

[Alt. 1: From executor, if benefits were payable to participant’s estate]:

I am the [ TITLE, SUCH AS EXECUTOR, ADMINISTRATOR, OR PERSONAL REPRESENTATIVE] of the estate of the Participant, who was a participant in the Plan. I enclose a certificate evidencing my appointment. In that capacity, I am transferring the Participant’s interest in the Plan to the beneficiary/ies of Participant’s estate who is/are entitled to receive it under [THE TERMS OF PARTICIPANT’S WILL/APPLICABLE INTESTACY LAW].

[Alt. 2: From trustee of trust named as beneficiary]:

I am the Trustee of the [NAME OF TRUST] (the “Trust”) which was the named beneficiary of the Participant under the Plan. In my capacity as such Trustee, I am transferring the Participant’s interest in the Plan to the beneficiary/ies who is/are entitled to receive it under the terms of the Trust.

[Alt. 1: transfer to one beneficiary]

Accordingly, I hereby instruct and direct you to change the titling of this plan benefit to “[NAME OF BENEFICIARY TO WHOM THE BENEFIT IS BEING TRANSFERRED] as successor beneficiary of [NAME OF DECEASED PARTICIPANT].”

[Alt. 2: transfer to several beneficiaries, in separate accounts]

Accordingly, I hereby instruct and direct you to divide the benefit into [NUMBER OF SEPARATE ACCOUNTS TO BE ESTABLISHED] separate accounts, and to change the titling of

each such account to the name of one of the beneficiaries to whom the benefit is being transferred “as successor beneficiary of [NAME OF DECEASED PARTICIPANT].” The names, addresses, and Social Security numbers of the individual beneficiaries of the separated accounts are: [INSERT].

In accordance with the instructions for IRS Form 1099-R, this transfer is a plan-to-plan transfer and is not to be treated or reported as a distribution from the Plan. Please advise what if any further information or documentation you require to complete this transfer.

Yours truly, [SIGNATURE OF EXECUTOR OR TRUSTEE]

## Appendix C: Resources

### *Books*

Natalie Choate's book *Life and Death Planning for Retirement Benefits* (Ataxplan Publications; 7<sup>th</sup> ed. 2011) may be purchased for \$89.95 plus shipping by calling 800-247-6553, or through the author's website [www.ataxplan.com](http://www.ataxplan.com), or through [www.amazon.com](http://www.amazon.com).

For complete treatment of **fiduciary income tax**, see any of the following four treatises: Abbin, Byrle M., *Income Taxation of Fiduciaries and Beneficiaries* (CCH, 2007, 2 vols.); Boyle, F.L., and Blattmachr, J.G., *Blattmachr on Income Taxation of Estates and Trusts*, 15<sup>th</sup> Ed. (2007), Practising Law Institute, 810 Seventh Ave., New York, NY 10019, [www.pli.edu](http://www.pli.edu); Ferguson, M. Carr, Freeland, James L., and Ascher, Mark L., *Federal Income Taxation of Estates, Trusts, & Beneficiaries*, CCH/Wolters Kluwer (3<sup>rd</sup> Ed. 1999–2008); and Zaritsky, H. and Lane, N., *Federal Income Taxation of Estates and Trusts*, ("Checkpoint" On-line Edition, updated through May 2008; Warren, Gorham & Lamont) (cited as "*Zaritsky*").

### *Articles*

Doyle, J.W., "IRA Distributions to a Trust After the Death of the IRA Owner—Income or Principal?" *Trusts & Estates*, Vol. 139, No. 9, p. 38 (Sept. 2000).

Golden, A.J., "Total Return Unitrusts: Is This a Solution in Search of a Problem?," 28 *ACTEC Journal* Vol. 2, p. 121 (Fall 2002).

Jones, Michael J., "Transferring IRAs," 145 *Trusts & Estates* No. 4 (April 2006), p. 38.

### *Drafting systems for estate planning lawyers*

If you are a new estate planner, or if you are the only estate planner in your firm, or if you are a general practitioner who needs to keep up with estate planning techniques as well as other areas of the law, or if for any other reason you would appreciate having a good set of estate planning document forms that have been thought through (and are kept up to date) by someone else, I recommend "Wealth Transfer Planning," from Interactive Legal Systems (<http://www.ilsdocs.com>). Written and maintained by two leading national estate planners, Jonathan Blattmachr and Michael L. Graham. "The system includes Wills, Revocable Trusts, GRATs, QPRTs, Irrevocable Insurance Trusts, a 2503(c)a Minor's Trust and more. Also included are strategic planning memoranda, client letters, executive summaries, and other agreements and materials. Extensive content help is available every step of the way, providing explanations for each question and guidance to the drafter."