TrustAsBene2009.wpd 3/25/09

MAKING RETIREMENT BENEFITS PAYABLE TO TRUSTS

By: Natalie B. Choate, Esq.
Nutter, McClennen, & Fish/Boston MA

This seminar handout is the full text of Chapter 6, plus selected other sections and forms, from the author's book *Life and Death Planning for Retirement Benefits* (www.ataxplan.com; see Appendix C). Copyright 2009 by Natalie B. Choate. All rights reserved.

Contents

6.1 Trust as Beneficiary: in General 3
6.1.01 What practitioners must know 3
6.1.02 Trust accounting for retirement benefits 3
6.1.03 Trust accounting: Drafting solutions 7
6.1.04 "Total return" or "unitrust" concept 8
6.1.05 Transferring a retirement plan out of a trust or estate 8
6.1.06 Individual retirement trusts (trusteed IRAs) 11
6.2 The Minimum Distribution Trust Rules 12
6.2.00 Summary of post-death minimum distribution rules 12
6.2.01 When and why see-through trust status matters 14
6.2.02 MRD trust rules: Ground rules 16
6.2.03 What a "see-through trust" is; the five "trust rules" 17
6.2.04 Dates for testing trust's compliance with rules 18
6.2.05 Rule 1: Trust must be valid under state law 18
6.2.06 Rule 2: Trust must be irrevocable 19
6.2.07 Rule 3: Beneficiaries must be identifiable 20
6.2.08 Rule 4: Documentation requirement 22
6.2.09 Rule 5: All beneficiaries must be individuals 24
6.2.10 Payments to estate for expenses, taxes 24
6.2.11 Effect of § 645 election on see-through status 26
6.3 MRD Rules: Which Beneficiaries Count? 26
6.3.01 If benefits are allocated to a particular share of the trust 26
6.3.02 Separate accounts rule not applicable 29
6.3.03 Beneficiaries "removed" by Finalization Date 31
6.3.04 Disregarding "mere potential successors" 32
6.3.05 Conduit trusts 33
6.3.06A Accumulation trusts: Introduction 35
6.3.06B Accumulation trust: O/R-2-NLP 35
6.3.07 Accumulation trust: "Circle" trust 37
6.3.08 Accumulation trust: 100 percent grantor trust 38
6.3.09 Powers of appointment 38
6.3.10 Combining two types of qualifying trusts 40
6.3.11 Planning choices: Trust for disabled beneficiary 42
6.3.12 Planning choices: Trusts for minors 44
6.3.13 Minors' Trusts: What the IRS should do 47
6.3.14 Planning choices: Trust for spouse 48
6.3.15 Generation-skipping and "dynasty" trusts 50
6.4 Trust Income Taxes: DNI Meets IRD 51
6.4.01 Income tax on retirement benefits paid to a trust 51

6.4.02 Trust passes out taxable income as part of "DNI" . . . 52
6.4.03 Trust must authorize the distribution . . . 54
6.4.04 Trusts and the IRD deduction . . . 55
6.4.05 IRD and the separate share rule . . . 55
6.4.06 IRD, separate shares, and discretionary funding . . . 57
6.4.07 Income tax effect of transferring plan . . . 58
6.4.08 Funding pecuniary bequest with right-to-receive IRD . . . 59
6.5 Putting it All Together . . . 60
6.5.01 Trust as beneficiary: Checklist . . . 60
6.5.02 Boilerplate provisions for trusts named as beneficiary . . . 61
6.5.03 Advance rulings on see-through trust status . . . 61
6.5.04 Should you use a separate trust just for the retirement benefits? . . . 62
Appendix A: Selected Sections from Other Chapters of Life and Death Planning . . . 63
1.6.07 When is a trust for the spouse the same as the spouse? . . . 63
2.3.01 Definition of IRD; why it is taxable . . . 64
2.3.02 When and to whom IRD is taxed . . . 65
2.3.03 Tax on transfer of right-to-receive IRD . . . 65
2.3.04 Income tax deduction for estate tax on IRD . . . 65
2.3.05 Who gets the § 691(c) deduction . . . 66
3.3.02 Drawbacks of trust for spouse compared with spousal rollover . . . 66
3.3.01 Leaving benefits to…marital trust: Overview . . . 67
3.3.03 IRS regards benefits, trust, as a separate items of QTIP . . . 67
3.3.05 The "entitled" requirement; income vs. MRD . . . 68
3.3.06 Distribute all income to spouse annually . . . 68
Appendix B: Selected Forms . . . 69
Appendix C: Bibliography & Resources . . . 77

Abbreviations Used in this Handout

§	Refers to a section of the Internal Revenue Code of 1986, as amended through 2008, unless otherwise indicated.
¶	Refers to a section of the author's book *Life and Death Planning for Retirement Benefits* (6th ed., 2006; 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.
Code	Internal Revenue Code of 1986.
DNI	Distributable net income. ¶ 6.4.02.
IRA	Individual Retirement Account. § 408.
IRD	Income in respect of a decedent. ¶ 2.3 (Appendix A).
IRS	Internal Revenue Service.
IRT	Individual retirement trust (trusteed IRA). ¶ 6.1.06.
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.
WRERA	Worker, Retiree, and Employer Recovery Act of 2008.

Acknowledgments

I acknowledge with appreciation the helpful comments of Jonathan Blattmachr, Esq., Dan Wentworth, Esq., of Fidelity Investments, and Seymour Goldberg, Esq., CPA.

6.1 Trust as Beneficiary: in General

6.1.01 ***What practitioners must know***

When a trust is named as beneficiary of an IRA or other retirement plan, the practitioner needs to know:

- ✓ How trust accounting concepts of "income" and "principal" will apply to the benefits. ¶ 6.1.02–¶ 6.1.04.

- ✓ How the trust can transfer the retirement benefits, intact, to the trust beneficiaries. ¶ 6.1.05.

- ✓ What a "trusteed IRA" (or "individual retirement trust") is, and how it differs from a custodial IRA payable to a trust as beneficiary. ¶ 6.1.06.

- ✓ Whether the trust qualifies as a "see-through trust" for purposes of the minimum distribution rules (¶ 6.2–¶ 6.3), and how to determine whether such qualification even matters (¶ 6.2.01).

- ✓ How retirement plan distributions will be subjected to federal income tax as they pass to a trust, or through a trust, including the special "DNI" rules applicable to income in respect of a decedent. ¶ 6.4.

- ✓ When a trust for the benefit of the participant's spouse is entitled to the special tax deals that apply when the participant names the spouse individually as beneficiary. See ¶ 1.6.07 (Appendix A).

- ✓ How to assure that retirement benefits left to a marital deduction trust will qualify for the federal estate tax marital deduction. See ¶ 3.3.01–¶ 3.3.06 (Appendix A).

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) 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 income ≠ federal gross income. A retirement plan distribution generally will constitute gross income to the trust for federal income tax purposes (¶ 6.4.01), 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 trust "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 (¶ 6.2.00); 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 distribution is the trust's "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 what's left (about $650,000) after paying income taxes and pays the income (interest and dividends) from the investments to Jorge's son.

B. Trust income ≠ MRD. "Income" for trust accounting purposes also does not mean the same thing as minimum required distribution (MRD; see ¶ 6.2.00). 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 has been 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 (ESOP; § 409), 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 § 404(k). The Comment makes it clear that § 409(b) was intended to apply *only* to a plan that, by its terms, distributes dividends and interest directly to the participant or beneficiary, and not to the typical IRA or other self-directed retirement plan: "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 Section 409(c)." Emphasis added.

UPIA § 409(c) governs retirement plan distributions not covered by § 409(b), and accordingly is the provision that will govern the vast majority of retirement plan distributions received by trusts. Here is what § 409(c) 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 [account balance] ÷ [40], i.e., only 2.5 percent of the value of the retirement benefits. That is already a low percentage, and the MRD under UPIA § 409(c) will be only 10 percent of that, a minuscule amount. It seems unlikely that a trust donor would choose this particular formula for determining the amount of "income" distributed to the life beneficiary. Another problem with the 10 percent rule is that the IRS rejects it as a measure of "trust income" for marital deduction purposes; see "D" and "E."

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.

D. When the IRS cares about trust accounting. Sometimes, the IRS does not "care" how you define income for trust accounting purposes. For example, if your trust says "The trustee may pay my son such amounts of the income of the trust as the trustee deems advisable," and the trust defines "income" as any amount the trustee receives on a Monday or Tuesday, while amounts received on other days are "principal," the IRS doesn't give a hoot. However, there are some situations in which it DOES matter to the IRS whether an item is considered income or corpus for trust accounting purposes. The most important of these situations is the *marital deduction trust*; see "E." 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 *Special Report: Retirement Benefits and the Marital Deduction (Including Planning for the Noncitizen Spouse)* (see Appendix C of this handout); 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.

E. Income for a marital deduction trust. Generally, the surviving spouse must be entitled for life to all income of a trust (or other asset held for her benefit) in order for such trust (or other asset) to qualify for the federal estate tax marital deduction. § 2056(b)(7). This section "E" 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 ¶ 3.3.01–¶ 3.3.06 (Appendix A) for how to meet the "entitled" requirement, and other requirements to obtain the marital deduction for retirement benefits left to a trust.

The IRS's rules for whether it will respect the governing instrument's (or state law's) definition of income begin with the Code definition in § 643(b) ("income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law"). Treasury regulations provide that the "income" of a trust is generally determined under the governing instrument and applicable state law, with certain limits. Regs. § 1.643(b)-1, § 20.2056(b)-5(f)(1). One of the limits is that an allocation between income and principal pursuant to local law "will be respected if local law provides for a *reasonable apportionment* between the income and remainder beneficiaries of the total return of the trust for the year…." Emphasis added. The regulation provides, as an example of "reasonable apportionment," a state law (such as UPIA 1997) allowing total return unitrusts (¶ 6.1.04), *provided* that income is defined as fixed percentage (between three and five percent) of the trust's assets, determined annually.

As this author predicted would happen (in the article "Trustees' Dilemma with Section 643," *Trusts & Estates*, Vol. 143, No. 7, July 2004, p. 26), 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. Accordingly, under Rev. Rul. 2006-26, a trust that uses the 10 percent rule to determine the surviving spouse's income under a marital trust will not qualify for the marital deduction.

In Rev. Rul. 2006-26, the IRS 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. In the IRS's view, the income of the retirement plan is either the plan's <u>internal investment income</u> ("trust-within-a-trust" concept; see ¶ 6.1.03(B)) or an acceptable (i.e., 3%–5%) <u>annual "unitrust" percentage amount</u> (see ¶ 6.1.04). Accordingly, when drafting a marital trust that is to be named as beneficiary of a retirement plan, it would be advisable to specify one of these methods of determining income. See Form 4.5, Appendix B, for an example. See ¶ 3.3.01–¶ 3.3.06 (Appendix A) generally regarding drafting a marital deduction trust.

Some states (*e.g.*, Pennsylvania and Texas) that have adopted the UPIA 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, these 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. Of course some other states have not adopted the 1997 UPIA at all. The bottom line is that 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 problem discussed in ¶ 6.1.02(C): draft a totally discretionary trust ("A"); define income as it applies to retirement plan benefits ("B"); or use the "unitrust" approach (¶ 6.1.04). For a marital deduction trust, use "B" or the "unitrust" approach; do not use the "A" approach.

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 "income" definition 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, including all thereof, 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 characterized 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 (see ¶ 6.1.02(E)).

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 perfectly, 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 you walk him through the alternatives.

Second, see ¶ 6.1.02(D) and (E) if the trust must comply with the IRS's definition of income.

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 investment account. The IRS has approved this approach for marital deduction trusts. ¶ 6.1.02(E). See Form 4.5, Appendix B.

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 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 minimum required distribution 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 (¶ 10.1.04), 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" concept

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. For an excellent, readable, and practical analysis of the reasons for this trend, the methods of implementing the idea, and its pros, cons, and pitfalls, see Al Golden article in the Bibliography (Appendix C). The UPIA 1997 permits the unitrust method of trust accounting.

The IRS will accept a state-law definition of income based on the unitrust method if the annual fixed percentage that the income beneficiary is entitled to 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.

6.1.05 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 its residuary beneficiaries.

The transfer of an inherited retirement plan or IRA from a trust or estate to the residuary 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. See Form 5.2, Appendix B, for how to do the transfer.

A. Examples of fiduciary transfers of inherited retirement plans. Here are some common examples of such transfers:

Foster Example: Foster names the Foster Revocable Trust as beneficiary of his IRA. 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 Credit Shelter 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 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.

Stanley Example: Stanley names his testamentary trust as beneficiary of his IRA. The trust provides that, after Stanley's death, the trustee is to pay income of the trust to Mrs. Stanley for life. On her death, the trust is to terminate, with the principal of the trust passing to Stanley's two children, A and B. The trustee takes annual MRDs from Stanley's IRA computed using the life expectancy of Mrs. Stanley, which is 18 years, as the ADP (¶ 6.2.01). Mrs. Stanley 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 divide the inherited IRA (which is now titled in the name of "Stanley Testamentary Trust, as beneficiary of Stanley, deceased") into two equal inherited IRAs, one titled in the name of "Child A as successor beneficiary of Stanley, deceased," and the other similarly titled for Child B. The trustee has transferred the IRA from the testamentary trust to the two children.

B. Income tax effects. Generally, the transfer of an inherited retirement plan from a trust or estate to the beneficiaries of the trust or estate is a neutral (nontaxable) event for income tax purposes, and the transferee-beneficiary will be taxable on plan distributions occurring after the transfer. ¶ 6.4.02(E), ¶ 6.4.07. The exception is that the transfer of an inherited plan in fulfilment of a *pecuniary* bequest will generally trigger realization of income. ¶ 6.4.08.

C. PLRs and IRA providers. Countless 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 2001-09051; 2003-29048 (IRA payable to a trust divided into four "sub-IRAs," each to be held by one of the individual former trust beneficiaries); 2004-33019; 2004-

49040–2004-49042; 2005-26010; 2006-52028; 2007-40018; 2007-50019; 2008-03002 (annuity contract); and 2008-26028.

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 -38044, and M. Jones article cited in the Bibliography.

For PLRs permitting retirement benefits to be transferred, intact, out of an estate to the estate beneficiaries, *Special Report: Estate Administrator's Guide to Retirement Benefits* (Appendix C).

Unfortunately, PLRs cannot be cited as authority. ¶ 6.5.03. The PLRs cite Rev. Rul. 78-406, 1978-2 C.B. 157, which established the rule that a custodian-to-custodian transfer of an IRA does not have to meet the requirements of a rollover, and that such a transfer can be initiated by the beneficiary after the participant's death. However, Rev. Rul. 78-406 did not deal specifically with transferring an IRA from a terminating trust (or estate) to the trust (or estate) beneficiaries.

Some IRA providers (see list posted at www.ataxplan.com/bulletin_board/ira_providers.htm) readily permit these transfers, upon receipt of proper instructions from the fiduciary of the trust or estate, plus (in some cases) an opinion of counsel. However, some IRA providers balk at permitting these transfers. A fiduciary faced with an IRA provider's refusal to allow transfer of the inherited IRA to the trust or estate beneficiaries has four choices. #1. Cash out the plan and pay the income tax, giving 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 a private letter ruling from the IRS, 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 a plan-to-plan transfer 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. IRA providers welcome such transfers because they know the purpose of the transfer is to allow the beneficiaries to keep the account alive for many more years.

D. Qualified plans; anti-alienation rule. If the benefits are in a qualified plan rather than an IRA, the question arises whether a transfer of the benefits from a trust (or estate) to the beneficiaries violates the rule that "benefits provided under the plan may not be assigned or alienated." § 401(a)(13)(A).

§ 401(a)(13) should not apply to this type of transfer. § 401(a)(13) prohibits arrangements (such as pledges and garnishments of benefits) "whereby a party acquires…a right…enforceable against the plan in, or to, all or any part of a plan benefit which…may become payable to the participant or beneficiary." § 1.401(a)-13(c)(1)(ii). The transfer of an inherited plan from a terminating trust or estate is a transfer *to* the participant's beneficiary, not a transfer that takes benefits *away* from the beneficiary. See PLR 2005-20004, approving the transfer of a 401(k) plan from the participant's estate to a charitable residuary beneficiary (without mentioning § 401(a)(13)).

6.1.06 ***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 payable to a separate trust as beneficiary.

An IRT can combine the *substantive terms* of a trust and the *tax deferral* 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.

Here are some reasons a client might consider using an IRT instead of the more common custodial IRA. Keep in mind that not every provider's IRT necessarily provides all these advantages:

A. **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.

B. **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(F), ¶ 6.3.12(A).

C. **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.

Successor Beneficiary Vs. Contingent Beneficiary

A successor beneficiary is not the same as a contingent beneficiary. A contingent beneficiary inherits the plan only if the primary beneficiary predeceases the participant or disclaims the benefits. If the primary beneficiary survives the participant and does not disclaim, the contingent beneficiary is out of the picture—he/she has no rights whatsoever. Later, the beneficiary who actually inherited the account (whether it was the primary or the contingent beneficiary) may die while there is still money in the account. Whoever becomes the owner at that point is the "successor beneficiary."

D. **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.

E. **Reduce legal fees**. An IRT typically offers the participant a limited menu of the most popular post-death payout options, such as: outright to the beneficiary; beneficiary limited to MRDs (or spouse-beneficiary limited to greater of income or MRDs), with or without additional payments in the trustee's discretion. 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, because the trust terms are pre-drafted and included in the IRT document.

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.

The IRT normally is not drafted by the participant's estate planning lawyer; it is a printed form pre-drafted by the IRA sponsor, for which the IRA sponsor has obtained IRS approval (similar to a "prototype" pension plan), and which the participant then adopts, typically by making check-the-box choices in, and signing, a printed adoption agreement. Not all IRA sponsors offer IRTs. Two that do are Merrill Lynch and KeyBank.

6.2 The Minimum Distribution Trust Rules

This ¶ 6.2 briefly summarizes the "minimum distribution rules" that apply on the death of a retirement plan participant, then explains how those rules apply when a trust is named as beneficiary of a retirement plan.

Suspension of Minimum Required Distributions for 2009

As this section explains, under the "minimum distribution rules" of § 401(a)(9), individuals over age 70½ (and beneficiaries of inherited retirement plans), are normally required to take a "minimum required distribution" from their owned (or inherited) retirement plans and IRAs each and every calendar year. However, as a result of WRERA (enacted 12/11/2008), the minimum distribution requirement is suspended for the year 2009 for IRAs and all other defined contribution plans. Thus, whenever this section indicates a distribution must be taken, you need to insert "except for 2009!" See § 401(a)(9)(H) ("Temporary Waiver of Minimum Required Distribution") and IRS Notice 2009-9, 2009-5 I.R.B. 419.

6.2.00 ***Summary of post-death minimum distribution rules***

This summary gives a basic overview of the post-death "minimum required distribution" (MRD) 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 generally Chapter 1 of *Life and Death Planning for Retirement Benefits,* or the *Special Report: Tax Pro's Guide to the Minimum Distribution Rules* (Appendix C). Section references in this ¶ 6.2.00 tell you where to find more detail on the particular subject in either the book or the Special Report.

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. The Code sections are terse and general; 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 for defined contribution plans, one applicable to the original owner of the retirement plan (the "participant"), called the lifetime distribution rules (¶ 1.3, ¶ .14), the other applicable to beneficiaries who inherit a plan (the post-death rules) (¶ 1.5).

Both lifetime and post-death MRDs are calculated in the same basic manner. In each "distribution year," 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. ¶ 1.2. 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. ¶ 1.9.

The MRD is indeed just a minimum; the participant or beneficiary is always free to withdraw more than the MRD. ¶ 1.2. 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. ¶ 1.2. 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. ¶ 1.5.10.

Most of the MRD rules have at least one exception!

On the participant's death, the minimum distribution rules apply to the beneficiary. The post-death rules differ somewhat depending on whether the participant died *before* or *after* his "required beginning date" (RBD) with respect to the plan in question. For IRAs, the RBD is April 1 of the year following the year the participant reaches age 70½. For 403(b) plans and some qualified (§ 401(a)) plans, the RBD is April 1 of the year following the later of the year the participant reaches age 70½ or the year the participant retires. ¶ 1.4. Also, the lifetime MRD rules do not apply to "Roth IRAs," so with a Roth IRA death is always "before the RBD." ¶ 5.1.03.

The post-death distribution rules also depend on whether the participant left his benefits to a particular kind of beneficiary, called a "designated beneficiary." Designated beneficiary means one or more individuals and/or "see-through trusts" (¶ 6.2.01–¶ 6.2.11). ¶ 1.7.03. An estate cannot be a designated beneficiary because it is not an individual. ¶ 1.7.04.

If the participant died on or after his RBD, leaving his benefits to a designated beneficiary, the ADP for the benefits is the life expectancy of the beneficiary or of the participant whichever is longer. In addition, the beneficiary must take the MRD for the year of the participant's death, to the extent the participant didn't take it himself. ¶ 1.5.04.

If the participant died before his RBD, leaving his benefits to a designated beneficiary, the ADP for the benefits is the life expectancy of the beneficiary (or in some cases, if elected by the beneficiary or required by the plan, the five-year rule; see below). ¶ 1.5.03.

When benefits are payable over the life expectancy of the 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, 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. ¶ 1.2.03.

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. ¶ 1.1.03.

If the designated beneficiary is the participant's surviving spouse, different rules apply. ¶ 1.6. 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." ¶ 3.2. Special rules also apply when there are multiple beneficiaries; generally, all beneficiaries must be individuals (or else participant is deemed to have "no designated beneficiary"), and if all are individuals the oldest individual's life expectancy is the ADP. Multiple beneficiaries may be able to divide the inherited plan into "separate accounts" after the participant's death to avoid these rules (unless they inherit through a trust; see ¶ 6.3.02). See ¶ 1.7.05. Another way to "correct" the beneficiary designation after the participant's death is to distribute or disclaim all benefits left to an "undesirable" beneficiary by the "Beneficiary Finalization Date"; see ¶ 6.3.03.

If the participant dies without having left his benefits to a "designated beneficiary," the benefits must be paid out under the no-DB rules. The no-DB rules would apply, for example, if the participant left benefits to his estate (¶ 6.2.10) or to a trust that did not pass the "IRS trust rules" i.e., a trust that did not qualify as a see-through trust. ¶ 6.2.03. The no-DB rule that applies if the participant died before his RBD is that the benefits must be paid out no later than the end of the year that contains the fifth anniversary of the date of death ("five-year rule"). ¶ 1.5.06. However, if death occurred in the years 2004–2009, the deadline becomes the end of the year that contains the sixth anniversary of the death. § 401(a)(9)(H)(ii)(II). Under the five- (or six-) year rule, annual distributions are not required. The no-DB rule that applies if the participant died on or after his RBD is that the benefits must be paid out over what would have been the remaining single life expectancy of the participant (had he lived). ¶ 1.5.08.

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 (¶ 6.2.00). 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" (¶ 6.2.00). Usually, distribution over the life expectancy of a beneficiary provides substantially longer deferral than distribution under the no-DB rules.

However, the mere 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. For example, making benefits payable to a trust of which the spouse is the life beneficiary results in substantially less income tax 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 [reproduced in Appendix A].

Also, complying with the trust rules does not solve the problem of high trust income tax rates (¶ 6.4.01).

Another reminder: Complying with the IRS's minimum distribution trust rules is not a requirement of making retirement benefits payable to a trust. If a trust named as beneficiary of a

retirement plan flunks the rules, the trust still receives the benefits; it just does not get to use the life expectancy of the oldest trust beneficiary as the Applicable Distribution Period (ADP).

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

A. Plan offers only lump sum distributions. Many qualified retirement plans (QRPs) do not permit the life expectancy payout. Prior to 2007, there was no point in qualifying a trust as a see-through trust with respect to benefits payable under this type of plan, because the trust would still be forced to take a taxable lump sum distribution of the benefits—the "stretch" payout was simply not available under the plan. For 2007 and later years, under § 402(c)(11) (added by the Pension Protection Act of 2006), a trust named as beneficiary should be able to have the lump sum transferred (by trustee-to-trustee transfer *only*) to an "inherited IRA" in the name of the decedent and payable to the trust as beneficiary. Two requirements will need to be met for this to occur: The trust must be a see-through trust (¶ 6.2.03); and (for years prior to 2010) the retirement plan must permit this type of "nonspouse beneficiary rollover." See IRS Notice 2007-7, 2007-5 I.R.B. 395, A-15, A-16, and § 402(f)(2)(A) (as amended by WRERA). So, as a result of the Pension Protection Act and WRERA, it may be important for a trust named as beneficiary to qualify as a see-through, *even if* the plan pays death benefits only in lump sum form.

B. Trust beneficiary older than participant (plans that permit stretch payouts). If the participant dies after his Required Beginning Date (¶ 6.2.00), leaving benefits to a see-through trust (¶ 6.2.03), 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 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, in the case of an IRA (or any other plan that permits the life expectancy payout) payable to the trust, 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:

C. Trust beneficiary older than participant (lump sum only plans). However, if the plan in question pays death benefits only in the form of a lump sum (see "A," above), 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. Why? Because the trust will be able to use a 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 (see "A"); and the nonspouse beneficiary rollover option is available only to individual beneficiaries and *see-through* trusts! IRS Notice 2007-7, A-16.

D. 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*, or the *Special Report: Charitable Giving with Retirement Benefits* (Appendix C).

D. 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 and ¶ 2.5 of *Life and Death Planning for Retirement Benefits*.

E. 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 ¶ 6.3.12(H) 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.

*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 itself, for various reasons, such as: In a conduit trust (¶ 6.3.05), the minimum distribution rules are essentially incorporated into the substantive provisions of the trust, so they should be mentioned in that case. In other types of trusts 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 the minimum distribution rules. In a marital deduction trust (see ¶ 3.3.01–¶ 3.3.06, 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 trust donor's intent, so specifying that the donor intends the trust to qualify as a see-through should help in that situation.

Caution! Don't Tie Trust Provisions TOO Closely to MRD Rules!

The enactment of WRERA (suspending minimum required distributions for the year 2009) revealed a weakness in some trust forms. If a trust that permits the trustee to distribute to the beneficiary ONLY the "required" minimum distribution and nothing else, the beneficiary will receive no distributions at all in 2009. If that's what the trust creator/participant intended, fine, but always consider giving the trustee to withdraw from the plan, and pass out to the trust beneficiary, MORE than the absolute minimum required distribution. My own conduit trust forms required the

trustee to distribute the "minimum required distribution," which was defined by a formula taken from the minimum distribution regulations. Under that form, the trustee must withdraw from the plan, and pay out to the trust beneficiary, the usual "minimum distribution" amount even in 2009 when no minimum distribution is actually required. I've amended this form (see Appendix B) to define minimum required distribution by the formula or such lesser or greater amount as the trustee is required to withdraw.

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.

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 in letter rulings sometimes seems to ignore this requirement.) 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. Thus, the remainder beneficiary of a conduit trust can be a trust that does *not* comply with the trust rules.

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 (¶ 6.2.00). Accordingly, Rule 5 is that:

5. All trust beneficiaries must be individuals. ¶ 6.2.09–¶ 6.2.10.

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 benefits paid to or through a trust; see ¶ 6.3.02. 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, but 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.

The documentation requirement must be met by October 31 of the year after the year of the participant's death. ¶ 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 disclaimers and/or distributions prior to the Beneficiary Finalization Date. See ¶ 6.3.03.

The all beneficiaries must be individuals test must be met as of the Beneficiary Finalization Date. See ¶ 6.2.10(C), ¶ 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 employee.” Reg. § 1.401(a)(9)-4, A-5(b)(2).

Employee vs. IRA Owner or Participant

The regulations refer to the participant as the “employee” because the minimum distribution regulations were written, first, for qualified plans. As applied to IRAs, “the IRA owner is to be substituted for the employee.” Reg. § 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.

Trust Does Not Have to Be Irrevocable as of RBD

Prior to revision of the minimum distribution regulations in 2001–2002, the IRS trust rules required the trust to be irrevocable as of the required beginning date. That rule has been abolished! Under the final regulations, the trust does not have to be irrevocable until the participant’s death.

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.

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. If Imelda withdraws $800,000 from the IRA, which is the maximum amount she can take out of Steve's trust, then the remaining $200,000 of the IRA that is still in the trust is not subject to Imelda's power to revoke and so the trust is irrevocable as to that part.

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.

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's 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," 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 on the same basis as "natural" issue, 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 should provide that older individuals cannot be later 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 or her 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 we cannot tell with certainty who is the oldest beneficiary of the trust.

For the effect of a power of appointment on the question of whether there are unidentifiable beneficiaries, see ¶ 6.3.09.

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 can be "removed" by disclaimer (as in PLR 2004-38044; see ¶ 6.3.09(B)), prior to the Beneficiary Finalization Date, 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 a disclaimer or distribution. In the Kit and Julia Example, Julia's future husband(s) can't disclaim (and we can't pay them their share of the benefits) 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. 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 of appointment 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 30, 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. For MRD purposes, everyone born in 1945 has the same life expectancy. PLR 2002-35038.

C. **Identifying who the beneficiaries are.** 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 all "identifiable" means is that the identity of the beneficiaries can be determined from the trust instrument, then the rule is redundant because presumably a trust under which the identities of the beneficiaries could NOT be determined

from the trust instrument would presumably not be valid under state law and so 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 fact, the rulings indicate exactly the opposite: 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. PLR 2006-08032 is similar.

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 this documentation with respect to post-death distributions is October 31 of the year after the year of the participant's death (or October 31, 2003, if later). Reg. § 1.401(a)(9)-4, A-6(b). This deadline is one month after the Beneficiary Finalization Date (¶ 6.3.03). The idea is that, once it is settled, on September 30 of the year after the year of the participant's death, exactly who the Designated Beneficiaries are, the trustee then has another month to certify this information to the plan administrator.

It is not necessary to wait until after September 30 to send the documentation to the Plan Administrator. Unless there is some reason to believe the information will change between the date of death and September 30, the trustee might as well send in the documentation as soon as possible; the trustee can always send amended documentation after September 30 (and before October 31) if a change does occur.

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 (¶ 1.3.01). 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 ¶ 1.6.07, 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. Note that in the case of lifetime MRDs 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) completed the certifications incorrectly, or sent 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 (based on the actual wording), 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, § 4975) 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 (except for purposes of the separate accounts rule, ¶ 6.3.02, and spousal rollover, ¶ 1.6.07 (Appendix A)) as if the participant had named them directly as beneficiaries. 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. Reg. § 1.401(a)(9)-4, A-3(a), § 1.401(a)(9)-8, A-11. Therefore, if any part of the trust's interest in the benefits will pass to an estate, there is a risk that the participant has no designated beneficiary. ¶ 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 his 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 estate will "flunk" Rule #5. However, despite suggestions in several PLRs (see, *e.g.*, PLR 9809059) that such a provision might disqualify a trust from having see-through status, 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.

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.

Many PLRs blessing see-through trusts do not even mention the subject; see PLRs 2003-17044, 2003-17043, 2003-17041; 2002-18039; 2002-11047; and 2002-08031. Every letter ruling that *does* mention such a clause in a trust finds some reason why the trust nevertheless qualifies as a see-through, based on one of the following rationales:

A. **Document prohibits use of benefits for this purpose.** 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 in question 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).

B. **State law protects the benefits.** 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 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.

C. Benefits will not be so used after Beneficiary Finalization Date. PLRs 2004-32027–2004-32029 confirm that, even if the participant's estate is 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), the estate can be "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). 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 trust as of the Beneficiary Finalization Date.

In these PLRs, "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 blessed the trust as a see-through, ruling that on the applicable September 30 the only remaining beneficiaries of the trust were the participant's three children.

D. There are no other assets available. In PLRs 2004-32027–2004-32029, the IRS conceded that the trust's contingent liability to pay additional estate taxes even *after* the Beneficiary Finalization Date (for example, if the tax bill went higher as a result of audit) did not disqualify the trust, despite the fact that such additional tax payments would have to come out of the IRA. The IRS does not give any particular rationale for this conclusion, just the conclusion.

In PLR 2004-40031, section 8.7(v) of the trust named as beneficiary of the participant's plans gave the trustee discretion to pay the participant's expenses of last illness, estate taxes, and probate costs. The estate was insolvent, so the trustee and an estate creditor sought a court order to pay some of the estate's expenses from the trust. Applicable state law exempted the benefits from claims of the participant's and beneficiary's creditors, but the court nevertheless ordered the trust to use plan benefits to pay the estate's liabilities "because no other assets existed" to defray these expenses. The IRS ruled that it would not treat "the creditors referenced in section 8.7(v)" of the trust as beneficiaries of the trust for MRD purposes.

The bottom line here is that there is no PLR or other IRS pronouncement in which the IRS has disqualified a trust either on the basis of a trust 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 understand that it would be absurd to disqualify a trust 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 estate and revocable trust can make an election to be treated as a single combined entity for income tax purposes during the administration period. § 645. Even though the effect of such 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 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), and that proper documentation has been supplied to the plan administrator (Rule 4; ¶ 6.2.08). 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 may be disregarded. This involves a two-step process.

The first step is to 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.

The second step is to look at the beneficiaries who *could* potentially share in the retirement benefits and see whether any of them 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–¶ 6.3.10).

*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 separate shares or subtrusts, and the retirement benefits are allocated fewer than all of such shares or "subtrusts." The question discussed here is whether the "identifiable" and "all-beneficiaries-must-be-individuals" tests (MRD trust rules 3 and 5) are applied to the entire trust (i.e., all possible beneficiaries of all 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 share of the retirement benefits?

One typical example would be a trust that divides, upon the participant's death, into a marital and credit shelter trust and under which the benefits are allocated entirely to the marital trust; see Foster Example, ¶ 6.1.05(A). 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. As the following discussion shows, 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.

A. The principle that *should* govern: "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 rules make clear that it is not *all* beneficiaries of the trust who are so treated, but rather only the beneficiaries of a 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."

Does the IRS agree with this interpretation? The few IRS pronouncements (all of which are in private letter rulings) are inconsistent. Sometimes the IRS seems to confuse this question with the entirely different issue of "separate accounts" treatment (¶ 6.3.02).

B. Subtrust is named directly as beneficiary of the benefits. One thing is clear: If the participant's beneficiary designation form names the subtrust 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 named as beneficiary. PLR 2006-07031. See Form 3.4 (designation of contingent beneficiary), Appendix B, for an example of how to leave 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 proposed regulations), in which all pre-residuary beneficiaries of a trust (including charities) were ignored in determining the ADP 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 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.

Scott Example: Scott's IRA is payable to the Scott Trust. At his death the assets of the Scott 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 Scott 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 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 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; see ¶ 6.2.10(A). 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, but 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.

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. PLR 1999-03050, decided under the proposed regulations, dealt with a three-share trust involving community property. The trustee was required to allocate the surviving spouse's share of community property (including pension benefits) to "Trust A," of which the surviving spouse was sole beneficiary (because she had the absolute right

to withdraw all its assets; see ¶ 6.3.08). The trustee was required to allocate the decedent's interest in any qualified plans to "Trust B," unless there were insufficient other assets to fund Trust C. Because there were sufficient other assets to fund Trust C, the trustee was required to allocate those benefits to Trust B. The taxpayers sought a ruling on who were the beneficiaries for MRD purposes.

The IRS treated this as a "separate accounts" issue (¶ 6.3.02): "Because the separation of plan benefits among Trusts A, B, and C occurred under the terms of Trust M rather than under the beneficiary designation form, the determination of Individual A's designated beneficiary can not be done on a separate account basis.…Thus, all beneficiaries of the trusts created under Trust M must be considered in determining the applicable distribution period." Thus, the IRS failed to distinguish between the separate accounts rule and the question of who are the beneficiaries "with respect to the trust's interest in the benefits."

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 Subtrust A and Subtrust 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, too. 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 (i.e., the opposite of PLRs 2005-28031–2005-28035).

6.3.02 ***Separate accounts rule not applicable***

Normally, if the participant's benefit under a plan "is divided into separate accounts and the beneficiaries with respect to one separate account differ from the beneficiaries with respect to the other separate accounts of the employee under the plan…the rules in section 401(a)(9) separately apply to such separate account...." Reg. § 1.401(a)(9)-8, A-2(a)(2).

However, the separate accounts concept applies at the *plan level*, not at the *trust level*. The *plan benefit* is not considered divided into separate accounts merely because it is payable to a *trust* that has multiple beneficiaries, even if the beneficiaries' shares constitute "separate shares" for purposes of allocating the income of the trust (¶ 6.4.05). Reg. § 1.401(a)(9)-4, A-5(c); PLR 9809059. Thus, for example, if an IRA is payable to a trust that is to immediately terminate on 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 them to the children (¶ 6.1.05), but (according to Reg. § 1.401(a)(9)-4, A-5(c)) the children's respective separate inherited IRAs (or "sub-IRAs" as the IRS calls them in some PLRs) cannot be treated as "separate accounts" for minimum distribution

purposes. In fact, "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).

If separate accounts treatment is desired for multiple subtrusts, the participant should name the subtrusts directly as beneficiaries in the beneficiary designation form, rather than naming the single funding trust as beneficiary. PLR 2005-37044; ¶ 6.3.01(B); see Form 3.4 (designation of contingent beneficiary), Appendix B, for an example of how to leave benefits in separate shares directly to separate trusts established under a single trust instrument.

Prior to issuance of the final minimum distribution regulations, separate accounts treatment *was* available for trust beneficiaries. In PLR 2002-34074 (issued in May 2002, after the final regulations were issued, though this PLR was decided under the proposed regulations), the 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 (it 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): "...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). Unfortunately, it is now clear that the IRS regards Reg. § 1.401(a)(9)-4, A-5(c), as precluding separate accounts treatment for any benefits that are payable to a single trust.

PLRs 2003-17041, 2003-17043, and 2003-17044, issued under the final regulations, are almost identical in relevant facts to PLR 2002-34074, but here the IRS reached exactly the opposite result. The 2003 rulings provided that *each child had to use the oldest child's life expectancy as the ADP*, because the IRA had been payable to the trust as named beneficiary and separate accounts could not be established for the beneficiaries of a trust (citing the new sentence in the regulation). This IRS position was confirmed in PLRs 2004-32027–2004-32029 and PLR 2006-08032.

However, 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! The participant died leaving his IRA to "Trust Y" as beneficiary. Under the terms of Trust Y, the IRA was divided upon the participant's death into four equal "subaccounts," one each for B, C, D, and E. E was to receive his share of Trust Y outright upon the participant's death while the other beneficiaries' shares were to be held in continuing trust. The IRS ruled that the trust qualified as a see-through, and that each of B, C, and D could take MRDs from his or her separate share of the IRA based on the life expectancy of the oldest member of the group consisting of B, C, and D *only*—not E! In other words, E's interest was treated as a "separate account," despite the fact that E inherited it through a trust.

Later PLRs have approved treating IRAs that were payable to a trust or estate, then transferred out of the trust or estate in percentage shares to the residuary beneficiaries, as separate accounts (following the split-up) *for all MRD purposes other than the determination of the ADP*. In all these rulings, 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; see ¶ 6.2.00) continued to apply to all the split-up accounts, but each one was clearly and definitely treated as a separate account for all other MRD purposes, 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, 2006-46028, 2006-47029, and 2006-47030, contrary to the IRS's own regulation providing that such accounts must be aggregated for § 401(a)(9) purposes.

6.3.03 ***Beneficiaries "removed" by Finalization Date***

The participant's Designated Beneficiary "will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the employee's death." Reg. § 1.401(a)(9)-4, A-4(a). This regulation gives two examples of how a date-of-death beneficiary can be "removed" by this Beneficiary Finalization Date. One example is by complete distribution of the entire benefit to which such beneficiary is entitled; the other is by a qualified disclaimer of the benefit.

However, if the beneficiary survives the participant, and so becomes entitled to ownership of the benefits (or some interest therein) as beneficiary, the beneficiary's later death (even if it occurs before the Beneficiary Finalization Date) does not "remove" him as a beneficiary. Reg. § 1.401(a)(9)-4, A-4(c).

A. **Distribution on or before September 30.** If a trust beneficiary's share of the retirement benefits that are payable to the trust has been entirely distributed to him as of the Beneficiary Finalization Date, that beneficiary is disregarded. He no longer "counts" for purposes of the MRD trust rules.

In PLRs 2004-49041–2004-49042, 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 in full by the Beneficiary Finalization Date (and rolled it over tax-free to her own IRA; see ¶ 3.2.08). 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.

Nonindividual trust beneficiaries (such as an estate or a charity) and older individual beneficiaries are disregarded if their interest in the trust is distributed to them prior to the Beneficiary Finalization Date. See PLRs 2006-08032, 2006-10026, 2006-10027, 2006-20026.

B. **Qualified disclaimer by September 30.** If a beneficiary disclaims his or her entire interest by the Beneficiary Finalization Date, he or she no longer "counts" as a beneficiary. 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 ¶ 6.3.09(B). For more on disclaimers of retirement benefits, see Chapter 4 of *Life and Death Planning for Retirement Benefits*.

C. Are there other ways to "remove" a trust beneficiary? The regulation seems to cite the beneficiary's receipt (or disclaimer) of his share of the benefits 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, not necessarily as the *only* ways this could be accomplished.

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; see PLR 2005-37044 (discussed at ¶ 6.3.10(B)), and PLR 2005-22012. No other permitted method has yet come to light. In PLRs 2005-28031–2005-28035 (discussed at ¶ 6.3.01(F)), the trustee's allocation of the benefits to the trust share of certain beneficiaries by the Beneficiary Finalization Date, though consistent with the trust instrument and required by state law, was not sufficient to allow the beneficiaries of other trust shares to be disregarded.

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 can be 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), without improving clarity. 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." Reg. § 1.401(a)(9)-5, A-7(c). 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) and "accumulation trusts" (¶ 6.3.06–¶ 6.3.09).

6.3.05 ***Conduit trusts***

"Conduit trust" is not an official term. It is a nickname 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 beneficiaries other than the conduit beneficiary are considered mere potential successors and are disregarded.

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 or beneficiaries any distribution the trustee receives from the retirement plan. The trustee has no power to hold and retain inside the trust ("accumulate," in IRS terminology) *any* plan distribution made during the lifetime of the individual conduit trust beneficiary.

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…In this case, B 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). *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. Therefore, the residuary beneficiaries of Trust P are mere potential successors to B's interest in Plan X." Emphasis added.

If the life beneficiary of the conduit trust lives to his life expectancy, he will have received 100 percent of the benefits and the remainder beneficiary will receive nothing. (The exception to this statement is a conduit trust for the surviving spouse; see ¶ 6.3.14.)

B. How a conduit trust is treated under the MRD rules. With a conduit trust, the retirement benefits are deemed paid "to" the individual conduit trust beneficiary for purposes of the minimum distribution rules, and accordingly the "all beneficiaries must be individuals" test is met. 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. Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2.

The conduit trust 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.

See ¶ 6.3.11(A) for using a conduit trust for a disabled beneficiary, ¶ 6.3.12(A) for a minors' trust, ¶ 6.3.14(A) for a life trust for the benefit of the participant's surviving spouse. See Forms 4.7, 4.8, Appendix B, for sample conduit trust forms.

C. Payments for beneficiary's benefit. Payment to the legal guardian of a minor or disabled beneficiary would be considered payment "to" the beneficiary for this purpose. See ¶ 6.3.11(A) regarding payment to another trust.

D. Payment of trust expenses. In PLRs 2004-32027–2004-32029 (discussed at ¶ 6.2.10), the IRS conceded 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. PLR 2006-20026 is similar.

E. Conduit trust for multiple beneficiaries. Though the IRS's only example on point deals with a conduit trust for just one beneficiary, many practitioners assume the principle should work equally well with multiple beneficiaries. For example, a trust that requires the trustee to pass out to the participant's living children in equal shares (or to one or more of the participant's children in proportions determined by the trustee) all distributions the trustee receives from a retirement plan payable to the trust, upon receipt, should pass muster as a conduit trust, *provided* that nothing can be paid from the retirement plan to anyone *other than* the members of this group so long as any one of them is alive.

F. Drawbacks of the conduit trust. The conduit trust is not suitable for every estate planning 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. Finally, there is 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 in the name of the decedent 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). 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).

G. Conduit trust drafting pointers. A participant considering leaving benefits to a stand-alone conduit trust might consider using an "individual retirement trust" (IRT) instead. ¶ 6.1.06.

Also, the life expectancy payout period under a conduit trust could last longer than the Rule Against Perpetuities would permit the trust to last. Even though the maximum payout period for post-death MRDs is an individual beneficiary's single life expectancy, the beneficiary whose life expectancy is being used as a measuring period could die more than 21 years before the end of his IRS-defined life expectancy, in which case (if his was the only measuring life), the trust could (depending on exactly what the dispositive terms are at that point) be in existence more than 21 years after the termination of "lives in being" at the commencement of the trust. The trust drafter should take care that the payout period required by the trust does not exceed the "perpetuities" period under applicable state law.

6.3.06A ***Accumulation trusts: Introduction***

Any trust that is not a conduit trust is an accumulation trust, 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; ¶ 6.3.08) 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 may be disregarded as mere potential successors, because the meaning of this term is clear in certain situations but unclear in others. The regulations offer no other guiding principles and contain only two examples, one of which is a conduit trust (¶ 6.3.05).

The other example, which is the only example the IRS provides of an accumulation trust that passes the rules, is the following 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 beneficiaries ("contingent beneficiaries") who take in that case is if they are considered "mere potential successors" 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 ¶ 6.3.06. 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 are mere potential successors.

6.3.06B ***Accumulation trust: O/R-2-NLP***

As explained at ¶ 6.3.04, the only example of a nonconduit see-through trust in the regulations is ambiguous. In PLR 2004-38044, the IRS for the first time resolved that ambiguity by approving an "outright-to-now-living-persons" (O/R-2-NLP) trust.

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 held in trust for him 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) 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. *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).

Under the approach exemplified in this PLR, and in PLRs 2005-22012 and 2006-10026 to the same effect, once you find a now-living person who is entitled to outright ownership of the benefits on the death(s) of the prior limited-interest beneficiary(ies), all other potential subsequent beneficiaries are disregarded as mere potential successors to the "outright ownership" remainder beneficiary. This type of trust is called O/R-2-NLP in this book.

It is recommended that practitioners use conduit trusts 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 where we have clear guidance that it "works." However, the O/R-2-NLP is not a panacea. Here are some limitations of the O/R-2-NLP approach:

❑ 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. If outright distribution is to be made to some remote future yet-unborn generation (for example, if it is to be made to the then-living issue of someone who now has no living issue), it is not clear how *if at all* the O/R-2-NLP approach applies. See ¶ 6.3.15(A).

- ❏ It has a serious drawback when young beneficiaries are involved. If (in PLR 2004-38044) any of the participant's children had been under age 30 at the time of the participant's death, it would have been necessary also to count, as trust beneficiaries, anyone who would inherit the trust if any of those children had died before reaching age 30. See PLRs 2002-28025 and 2006-10026; ¶ 6.3.12(D)–(F), ¶ 6.3.13.

PLRs 2006-10026 and -10027 illustrate this problem, while confirming the validity of the O/R-2-NLP concept: An IRA was left to a trust that was to terminate immediately upon the participant's death and pass outright to his child and grandchild, but with a proviso that the share of a beneficiary under 18 would be held in trust until the beneficiary reached age 25; and if such a beneficiary then later died before reaching age 25 his share would be paid to his heirs at law. The grandchild was under 18 at the time of the participant's death, so this provision was applicable. The grandchild's heirs at law-apparent (i.e., the people who would inherit his share of the trust if he died before age 25) were his parents. The IRS ruled that the trust qualified as a see-through trust; so far so good.

The IRS also ruled that the "countable" trust beneficiaries were: the participant's child and grandchild (which makes sense since both were direct trust beneficiaries), and also the grandchild's *other* parent (the wife of the participant's child), because she was a potential heir-at-law of the grandchild—even though she could share in the trust only if the grandchild (her child) died before age 25! So the ADP was the life expectancy of the oldest member of that group of three people.

This ruling continues the regrettable trend started in PLR 2002-28025, whereby the IRS ignores the overwhelming actuarial likelihood that a minor child will survive to age 25, 35, or even 45. It also continues the regrettable trend (started in PLR 2003-17041) of not allowing "separate accounts" treatment to multiple beneficiaries who take through a trust, even when the trust mandatorily terminates immediately upon the participant's death and is distributed outright (in mandatory shares predetermined by the participant) in separate shares to the individual beneficiaries (or to multiple trusts). See Reg. § 1.401(a)(9)-8, A-2(a)(2), and ¶ 6.3.02.

For how to have an O/R-2-NLP trust for a disabled beneficiary, see ¶ 6.3.11(B); for minors, see ¶ 6.3.12(C)–(F); for the participant's surviving spouse, see ¶ 6.3.14(B).

6.3.07 ***Accumulation trust: "Circle" trust***

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

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 are 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 is also called the "last man standing" approach, because it terminates the trust when only one of the original individual beneficiaries is still living and distributes the trust to that individual; see ¶ 6.3.12(C).

Why would anyone use a circle trust rather than an O/R-2-NLP trust? Because the validity of the O/R-2-NLP trust concept depends on private letter rulings interpreting an ambiguous regulation. See ¶ 6.3.06. A circle trust complies with the regulation without the necessity of relying on PLRs for how to interpret that regulation.

6.3.08 ***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) (or any other of the grantor trust rules, § 671–§ 677), then retirement benefits payable to such trust are deemed paid "to" such individual beneficiary for purposes of the minimum distribution rules, and the "all beneficiaries must be individuals" test is met. See, *e.g.*, PLR 2000-23030, in which the decedent's IRAs were payable to a trust that was a grantor trust as to the surviving spouse under § 676. 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.

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 the remainder beneficiary should 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/her 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 ¶ 6.3.09.

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 chooses to exercise this right, the trustee exercises 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 a 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), or for certain disabled beneficiaries (¶ 6.3.11(C)).

6.3.09 ***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 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, 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.

However, with an accumulation trust, remainder beneficiaries generally must be counted. (The presumed exception is the 100 percent grantor trust; see ¶ 6.3.08.) Thus, if an accumulation trust (other than, presumably, a 100 percent grantor trust) is to qualify as a see-through, all such potential appointees (and default takers) 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 that the parties want to use as the ADP. The following examples illustrate the possibilities:

A. Power to appoint to "issue" apparently is acceptable. 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 persons *among the class consisting of our issue* as my spouse shall appoint by her will" does not create a problem under this rule because the power is limited to a small, clearly-defined group of "identifiable" younger individuals. See, *e.g.*, PLRs 1999-03050 ("Trust B") and 1999-18065 ("Trust 2") approving trusts that contained powers to appoint principal among the participant's issue. Presumably in these PLRs the participant had some issue living at the time of his death; see ¶ 6.3.06.

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). 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).

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, namely the charity. For other ways to benefit charity with retirement benefits, see Chapter 7 of *Life and Death Planning for Retirement Benefits* or the *Special Report: Charitable Giving with Retirement Benefits* (see Appendix C of this handout).

D. Power limited to younger individuals. If the class of potential appointees is limited to *younger individuals*, there are letter rulings that suggest that the power of appointment is not a problem because all remainder beneficiaries must be individuals and it is possible to identify the oldest beneficiary of the trust. See PLR 2002-35038 blessing a trust that contained such a power, and similar PLR 2006-08032. Nevertheless, the power to appoint to a broad class of unknown individuals seems to violate the IRS's rule that the trust

beneficiaries must be "identifiable," which (in *other* letter rulings) they often seem to interpret as meaning that it must be possible to determine who are the trust's beneficiaries by perusing the trust instrument.

E. Implied 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. 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 in trust would cause a trust to flunk the trust rules unless the power is limited to appointing only to other trusts that comply with the rules…which is almost impossible to do, since one of the requirements is that a copy of the trust be given to the plan administrator by October 31 of the year after *the participant's* death.

6.3.10 ***Combining two types of qualifying trusts***

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 ¶ 6.3.08. 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 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.

Can one trust instrument contain both an accumulation trust and a conduit trust and still qualify as a see-through? Only if the conduit trust comes first.

A. 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? I.e., can it provide that, during the spouse's life, only *income* is distributed to the spouse, but after the spouse's death the trustee must distribute to the issue all distributions the trustee receives from the plan? No: 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 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.

How could you make this trust qualify? One way would be to provide for outright distribution to a younger individual if all of the participant's issue die before reaching age 30 (O/R-2-NLP; ¶ 6.3.06). The other would be to make the trust a conduit trust during the surviving spouse's life; if that is done, the trust does not need to be a conduit trust after her death, if she survives the participant (because remainder beneficiaries who come after the conduit beneficiary are disregarded as mere potential successors). ¶ 6.3.05.

B. "Toggle" trusts. PLR 2005-37044, involving an IRA that was payable to several trusts as named beneficiaries, illustrates an innovative planning idea, the "toggle trust." In this PLR, the decedent's beneficiary designation form left "IRA W" to nine separate conduit trusts for nine individuals. Upon the death of the individual conduit beneficiary, his or her separate trust would be paid partly to the other trust beneficiaries' shares and partly to beneficiaries appointed by the conduit beneficiary.

The remainder beneficiaries of the trusts included charities and older individuals as potential appointees; however, since the conduit beneficiary is considered the sole trust beneficiary, these remainder beneficiaries are disregarded for MRD purposes. ¶ 6.3.05(B).

However, the trust also provided for a "Trust Protector," who had the power to make certain amendments to any of the nine trusts. One amendment he could make would be to take away the "conduit" provision, and change the trust to an accumulation trust, with the beneficiary receiving distributions only in the discretion of the trustee. Another amendment the Trust Protector could adopt was to limit the remainder beneficiaries of any trust to only individuals younger than the life beneficiary of that trust.

There was no time limit mentioned in the ruling after which the Trust Protector could no longer exercise these amendment powers. However, there may have been such a time limit in the trust, since the ruling mentions that there was "additional language" in the trust referring to the exercise of the amendment power "after September 30 of the year following the calendar year of Decedent's death." It is hard to see how the IRS could have approved these trusts as see-throughs without such a time limit, because otherwise the Trust Protector could further amend the trusts, after the ruling was issued, in ways that would cause them not to qualify as see-throughs.

The Trust Protector exercised its power to amend one of the nine trusts, "Trust J." First, he converted Trust J from a conduit to an accumulation trust. Second, he limited the potential remainder beneficiaries of Trust J to individuals younger than the life beneficiary.

Interestingly, the question submitted to the IRS for ruling was whether the Trust Protector's *amendment* of the trust negatively affected the see-through trust status of any of the trusts. The IRS considered the matter from that point of view only, and did not get into the question of whether the Trust Protector's mere *power* to amend the trusts negatively affected the trusts' see-through status.

From this limited point of view the IRS was able to rule that the trusts, including the one trust that was amended by the Trust Protector, were see-throughs, 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 accordingly "may be treated as a part of" the original trust instrument; and were "treated as a disclaimer under the laws of" the applicable state. (The taxpayers had represented to the IRS that the Trust Protector's actions were "treated as a disclaimer for all purposes associated with this ruling request.")

The finding that state law treated this trust amendment as a "disclaimer" is critical to the IRS's favorable ruling. Since the MRD regulations explicitly approve "changes of beneficiary" made by means of a qualified disclaimer, so long as the disclaimer occurs prior to the Beneficiary Finalization Date (¶ 6.3.03), anything that state law explicitly recognizes as equivalent to a disclaimer is highly likely to win IRS approval. However, the Trust Protector's action was not a

disclaimer, and was nothing like a disclaimer. It is hard to imagine what the state law provision could have been that would "treat" this transaction as a disclaimer for any purpose.

As described in the ruling (which may or not be an accurate summary of the trust's actual language), the trust in PLR 2005-37044 was fatally defective and could not, without amendment, have qualified for see-through status. The conduit trusts were valid see-through conduit trusts—except for one thing: The Trust Protector had the power to amend those trusts to make them NOT conduit trusts. The Trust Protector had the power to turn the conduit trusts into accumulation trusts. As accumulation trusts, the trusts were defective, because the beneficiaries had the power to appoint the plan accumulations to charity (i.e., to a nonindividual beneficiary) or to older individuals. The Trust Protector had the power to modify those powers of appointment, to limit the appointees to individuals younger than the life beneficiary; but the Trust Protector apparently also had the power NOT to so limit the identity of the remainder beneficiaries.

Did the IRS simply miss this issue? Or was there additional trust language not quoted in the ruling, indicating that the trustee could not convert a trust to an accumulation trust unless he ALSO limited the remainder beneficiaries to younger beneficiaries? Or, is the IRS signaling that there is more room than previously suspected to "clean up" a trust by the September 30th deadline?

Though the trust in this ruling appears (based on what is quoted in the ruling) to have been defectively drafted, the concept of a "toggle" trust is both innovative and valid, PROVIDED it is not implemented in the manner that PLR 2005-37044 seems to suggest was used in "Trust T." For the toggle concept to work (unless the IRS has had an unannounced change of heart regarding the MRD trust rules), both sides of the "toggle" must be qualifying see-through trusts, and the trust instrument should establish the Beneficiary Finalization Date (¶ 6.3.03) as the deadline for exercise of the amendment power.

6.3.11 ***Planning choices: Trust for disabled beneficiary***

Here are options available for a trust intended to provide for a disabled beneficiary, when qualifying for see-through trust status is an important goal (¶ 6.2.01). Which type is best depends on whether the beneficiary needs to qualify for need-based government benefit programs and on who the remainder beneficiary is. If qualification for benefit programs is a goal, the donor should consult with an attorney who specializes in drafting this type of trust.

A. **Conduit trust.** A conduit trust (¶ 6.3.05) is not suitable if the beneficiary must qualify for welfare. The MRDs would have to be distributed to the beneficiary, and would be considered available income or assets to the beneficiary, thus forfeiting eligibility for welfare benefits. However, if qualification for these benefits is not an issue (for example, because the family is wealthy and 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.

Under a charitable remainder trust (§ 664), where the Code requires an annual unitrust or annuity payment to be made "to" the individual life beneficiary, the IRS has ruled that a payment to a trust for the benefit of a disabled individual can be treated as a payment "to" that individual, if various requirements are met (both as to the disability and as to the trust). Rev. Rul. 2002-20, 2002-1 I.R.B. 794 (see "D," below). To date there is no ruling comparable to Rev. Rul. 2002-20 that would

allow payments to be made to a trust for the benefit of a disabled beneficiary (rather than directly to the beneficiary or his guardian or custodian) to be treated as payments "to" the beneficiary for purposes of treatment as a conduit trust.

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 benefit 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 needs that are provided by the government programs such as support and health care. Such a trust would be considered an accumulation trust for MRD purposes, but would still qualify as a see-through if the trust principal passes outright at the disabled beneficiary's death to other now-living individuals, such as the disabled beneficiary's siblings. See ¶ 6.3.06.

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, since the life expectancy of the oldest member of the group will be the ADP. Thus, drafting this type of trust is "easy" if the disabled individual has living siblings who are younger or close in age, but impossible if there are no such suitable younger or close-in-age individual remainder beneficiaries.

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 (¶ 6.3.08). 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 ¶ 6.3.08) allowing the life expectancy of the handicapped beneficiary to be the ADP. It also allows distributions to be taxed at the beneficiary's rate. This approach can be particularly helpful if the beneficiary has no siblings or issue, and is not likely to have 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 § 664) 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 or her (as is normally required for CRTs) if various requirements are met, according to Rev. Rul. 2002-20, 2002-1 I.R.B. 794. For where to read more on charitable giving with retirement benefits, see Appendix C.

6.3.12 ***Planning choices: Trusts for minors***

Here are 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). Which type is best depends on the purpose of the trust: Is the trust to be the major source of support for an orphaned family, or is it just providing extra spending money for well-to-do children whose support is otherwise taken care of? Is the donor's main goal to be sure that the "stretchout" payout method is available, so the benefits become the minors' own retirement plans eventually? Or is the money most likely to be spent during the beneficiaries' childhood, for their support, education, and care? 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 will 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.

Trusts for minors often provide for a staged distribution of principal, *e.g.*, half at age 25, balance at age 30, or one-third at 30, one-half at 35, balance at 40. In view of the complications of transferring a retirement plan out of a trust (see ¶ 6.1.05), consider not using such staged distribution for retirement benefits, so as to minimize the number of times this issue has to be dealt with.

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

A. **Conduit trust (or IRT) for supplemental money.** Aunt Emily believes that leaving her IRA to her young nephews is a fine way to provide them with a nest egg, but knows that, if she names them directly as beneficiaries, they will simply cash out the account immediately upon her death. So she leaves the IRA to a conduit trust for them. ¶ 6.3.05. The purpose of the trust is to make sure that the nephews take advantage of the "life expectancy payout," whether they want to or not, and to provide professional management for the undistributed portion of the IRA. The nephews' support and education is paid for by their wealthy parents. The trustee is instructed to withdraw from the IRA, each year, the MRD (based on the life expectancy of the oldest nephew) and distribute it equally to the surviving nephews. Aunt Emily could also use an IRT in this situation. ¶ 6.1.06.

B. **Conduit trust for a primary support trust.** If the retirement 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.

On the other hand, if the retirement benefits are not substantial enough to justify establishing a separate trust, the conduit approach can make sense for benefits that are part of the corpus of a larger trust. The benefits are left to the same trust as all the other assets, but that trust contains the special "conduit" provisions requiring the trustee to pass through all retirement plan distributions. See Form 4.7, Appendix B.

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 does not require a letter ruling, on the theory 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.

C. **Circle Trust: Last man standing.** One solution is to provide that if, at any time, there is only one child living among the original group of minor beneficiaries, 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 minors. This is the "Circle Trust" approach (see ¶ 6.3.07). This approach makes it unnecessary to name some remainder beneficiary the donor doesn't really want to name (see E and F). The drawback is that if the provision is triggered the benefits could pass outright to very young individual, even an infant (through his legal guardian or a custodian for his benefit).

D. **O/R-2-NLP: The problem: 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 (¶ 6.3.06).

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 won't work with minor children who have no issue at the time of the participant's death. The last-man-standing approach (see "C") has the drawback that it could cause all the trust assets to be dumped out of the trust into the lap of a very young beneficiary in case of an unusual order of deaths. E and F below provide examples of other ways to implement the O/R-2-NLP trust concept for a minors' trust; with each, a separate trust just for the retirement benefits will be required, since the remainder beneficiary provisions would be different for the benefits than for the other assets.

E. **O/R-2-NLP: Fill in the blank.** Typically, the donor of a minors' trust would name a "wipe-out" 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 wipe-out beneficiary is a charity or other nonindividual, the trust will flunk Rule 5 (¶ 6.2.09); if the wipe-out beneficiary is simply "my heirs at law," the trust would flunk Rule 3 (because the oldest beneficiary is not identifiable; ¶ 6.2.07); and if the wipe-out beneficiary

is an individual who is older than the oldest minor child, the wipe-out beneficiary's (shorter) life expectancy will be the ADP.

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." So one approach is for the donor to plug in the name of a younger individual as the wipe-out 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 interesting in leaving money to.

F. **O/R-2-NLP: Leave it blank.** 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). The problem with the leave-it-blank approach is that the IRS's rulings approving this approach are seriously defective in reasoning, in that the rulings fail to mention what would happen to the benefits if the power of appointment was not exercised; realistically, the donor would still have to "fill in the blank" ("E") to cover this possibility.

G. **Whether to have a separate trust for each minor.** If the benefits are left to the typical "family pot" trust for the benefit of all of the donor's children collectively, then (assuming that 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 "spray" more money in the direction 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 remainder beneficiaries are the other siblings, you are right back with the oldest child's life expectancy being the ADP for all the trusts.

H. **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 term 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–F.

I. **Custodianship under UTMA.** For parents of minors where there are not enough assets to justify a trustee's fee, another choice 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 the person(s) obligated to support the minor are somehow co-beneficiaries 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.

*6.3.13 **Minors' Trusts: What the IRS should do***

The IRS position on O/R-2-NLP trusts produces absurd results.

Watson Trust Example: Watson dies at age 70, leaving his IRA to a trust. The trust provides that Watson's son Jackson is to receive income from the trust for life. On Jackson's death, the trust is to pass to Jackson's children, but each child's share is to be held in trust for such child until he or she reaches age 35. If all Jackson's children die without issue at a time when there is still money in the trust, the remaining trust funds pass to Watson's sister Dickie. At the time of Watson's death, Jackson is age 45, Dickie is age 68, and Jackson has two children living, who are ages 8 and 10. Under the current apparent IRS O/R-2-NLP concept, Jackson and his children are "limited" beneficiaries of the trust. The first "unlimited" beneficiary is Dickie. Therefore the trust beneficiaries for MRD purposes are Jackson, Dickie, and the two minor children, and 68 year-old Dickie is the oldest trust beneficiary. See PLR 2002-28025 (confirmed in PLR 2008-43042). This produces the utterly absurd result that we are required to ignore the over 95 percent actuarial likelihood that at least one of the two minor children will reach age 35; and we are required to treat Dickie as a trust beneficiary even though under the IRS's own actuarial tables Dickie's chance of surviving the other three beneficiaries approaches zero!

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 the interest in the benefits and trust 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 likes). 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 actuarial likelihood of attaining, according to the IRS’s own actuarial tables.

6.3.14 ***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).

A. Conduit trust as credit shelter or QTIP substitute. 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.

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. ¶ 1.6.07(A) [see Appendix A]. 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 determined using recalculation (¶ 1.6.06(D))…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!

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. A conduit trust may be fine if the participant just wants to make sure the spouse doesn’t spend the entire fund at once. Because the spouse will be considered the “sole beneficiary” of the trust, the trust can use the special minimum distribution rules available to a surviving spouse who is sole beneficiary (though not the spousal rollover).

There 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 participant would have reached age 70½, the IRS may 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 five-year rule on the death of the spouse. See ¶ 1.6.05 of *Life and Death Planning for Retirement Benefits*, and PLR 2006-44022.

B. Accumulation O/R-2-NLP trust. The typical QTIP or credit shelter trust is an accumulation trust, 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 terminates and passes outright to the participant's issue on the spouse's death, the trust passes the rules as an O/R-2-NLP trust, as long as at least one issue survives the participant. ¶ 6.3.06. The trust can provide whatever the participant wants it to provide regarding disposition of the trust assets if all the issue predecease the spouse, assuming the O/R-2-NLP interpretation of the regulations is correct. 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 or to the extent she disclaims her interest in the benefits as trust beneficiary; see ¶ 6.3.02 and Form 3.4, Appendix B.

C. Accumulation trust: issues' shares held until certain ages. If the trust does not pass 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. The options here are the same as described at ¶ 6.3.12(C)–(F) for a minors' trust; having the trust "convert" at that point to conduit trusts for the issues' shares will NOT work. ¶ 6.3.10(A).

D. Accumulation circle trust. Alternatively, provide that the trust terminates at such time during the participant's spouse's life as there are no issue of the donor living and passes outright to the surviving spouse (circle trust; ¶ 6.3.07). The circle trust would 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 issue predecease the spouse.

If 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; see ¶ 3.3.02 (Appendix A); if qualifying for the marital deduction is important, see ¶ 3.3.01–¶ 3.3.06 (Appendix A).

6.3.15 ***Generation-skipping and "dynasty" trusts***

The MRD trust rules pose unique challenges whether you are trying to avoid the generation-skipping transfer (GST) tax or take advantage of the GST exemption. For details on the GST tax, see § 2601–§ 2664 and sources in the Bibliography (Appendix C).

A. Perpetual or multi-generation 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 is appropriate in some cases, particularly if the client has no other assets suitable for a generation-skipping gift. Leaving the benefits directly to grandchildren outright, or to conduit trusts or O/R-2-NLP trusts for the benefit of "skip persons," poses no particular problems.

Too date, there is no IRS pronouncement either favorable or unfavorable regarding whether a trust that is not to vest in any member of any now-living generation (sometimes called a "dynasty" or "perpetual" trust) can qualify as a see-through. A multi-generation trust for the exclusive benefit of the participant's issue would satisfy the IRS's "identifiable" rule, if that rule requires nothing beyond the ability to identify the oldest beneficiary; see ¶ 6.2.07. Although such a trust does not seem to jibe with the Code's requirement that the benefits be paid out over the life expectancy of "the" designated beneficiary (since no individual ever has the right to receive the benefits), the IRS's minimum distribution regulations overrule the Code in several respects (¶ 1.2.01, #10) and perhaps this is one of them.

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); Reg. § 1.401(a)(9)-4, A-3(a), § 1.401(a)(9)-8, A-11. 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*. For a conduit trust form to solve this problem, see Form 4.8, Appendix B.

Another solution is to give the child the right to withdraw all of the trust principal during life with the consent of a trustee who does not have a substantial adverse interest 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, that 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 Trust Income Taxes: DNI Meets IRD

This ¶ 6.4 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*; see PLR 2002-09026.

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

The discussion here does not apply to a nontaxable distribution from a retirement plan; see ¶ 2.1.06 of *Life and Death Planning for Retirement Benefits* for a catalogue of no-tax and low-tax retirement plan distributions. This handout does not explain income tax considerations in connection with a trust's distributions to charity (including computation of the charitable deduction); for that subject, see sources in Appendix C.

This section deals extensively with **income in respect of a decedent (IRD)**. For more detail on IRD, see ¶ 2.3 of *Life and Death Planning for Retirement Benefits*, excerpts from which are reproduced in Appendix A of this handout to provide a basic explanation of IRD.

6.4.01 ***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. For income tax treatment of retirement benefits paid to individuals, see Chapter 2 of *Life and Death Planning for Retirement Benefits*.

However, there are several differences between trust 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 (¶ 6.4.02); and a trust is not subject to the reduction of itemized deductions under § 68 (¶ 6.4.04).

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" of § 671–§ 678; ¶ 6.3.08) 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 (35%) for taxable income in excess of $11,150 (2009 rates). For an individual, the top income tax bracket applies only to taxable income above $372,950. 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:

A. **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 ¶ 6.4.02.

B. **Charitable deduction.** A trust is entitled to an income tax charitable deduction for certain distributions it makes to *charity*. § 642(c). See Appendix C for where to read more on this.

C. **Transfer the retirement plan to a beneficiary.** A trust can transfer the retirement benefits, intact, to the trust beneficiary. Following such a transfer, distributions will be made directly to (and taxed to) the individual former trust beneficiary. ¶ 6.4.07.

D. **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 taxed at the beneficiary's rate rather than at the trust's rate. ¶ 6.3.08.

E. **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. ¶ 6.4.04.

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.

*6.4.02 **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 beneficiaries. § 651, § 661. The beneficiaries then pay the income tax on these distributions. § 652, § 662. This "DNI deduction" is limited to the amount of the trust's **distributable net income** or **DNI**. § 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, Example 6, 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, and CCA 2006-44016. See ¶ 6.4.04 regarding the IRD deduction.

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 dividends, 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 the governing instrument, state law, or established trustee practice calls for such gain to be allocated to trust income or certain other elaborate 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 ¶ 6.4.03.

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. **No DNI deduction for certain pecuniary bequests.** 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 quite unusual). § 663(a)(1), Reg. § 1.663(a)-1.

Thus a trustee's distribution in fulfilment 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.

D. No DNI deduction for distribution to charity. The trust does not get a DNI deduction for distributions to charity. § 651(a)(2), § 663(a)(2). Such a distribution will be deductible only if it qualifies for a charitable deduction. § 642(c). See Appendix C sources for more on this.

E. Transfer of the plan does not carry out DNI. Though a retirement plan *distribution* received by the 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." ¶ 6.4.07.

F. Allocation of DNI when separate share rule applies. Finally, 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 ¶ 6.4.05–¶ 6.4.06 for how this rule applies to retirement benefits.

*6.4.03 **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 often trusts are drafted without adequate thought being given to the income tax consequences of the retirement plan distributions. Trustees often 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:

Arthur Example: Arthur leaves his IRA to a credit shelter trust that requires the trustee to pay all income of the trust to Arthur's wife for life, and hold the principal in trust for distribution to Arthur's issue upon his wife's death. The trustee receives a minimum required distribution (MRD) from the IRA. Under the state law applicable to Arthur'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 Arthur'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 Arthur'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.

6.4.04 *Trusts and the IRD deduction*

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 ¶ 2.3.04 of *Life and Death Planning for Retirement Benefits*, Appendix A), 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 Appendix C. If the IRD is not passed out to the trust beneficiaries in DNI, then the IRD and the IRD deduction stay in the trust.

Under § 68, the itemized deductions of a high-income taxpayer may be reduced. ¶ 2.3.07. Since the deduction for federal estate taxes paid on IRD is an itemized deduction, it is adversely affected by § 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 benefits that will need to be cashed out shortly after the participant's death.

6.4.05 *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. ¶ 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 the age of 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, instead, 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, and not having to give each 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 distribution 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-corpus 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 Reg. § 1.652(b)-2(b) and Prop. Reg. § 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: No one beneficiary bears a disproportionate share of income tax just because he/she happened to receive more distributions in a particular year.

6.4.06 ***IRD, separate shares, and discretionary funding***

Scenario 3: Continuing the Jody Example from ¶ 6.4.05, 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. There are two possible interpretations of the separate share regulation in this situation. The first interpretation, which is apparently the most widely accepted, 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 "A" and "B" below for exceptions).

While this is certainly the most obvious interpretation of the words "could potentially be funded," it has a defect, namely, that it overrides a specific provision of the governing instrument. A second possible interpretation would be that, if the fiduciary has, and exercises, a power to allocate the IRD to a particular share, there is no longer an open question of which shares could "potentially be" funded, because one particular share *has* been funded with the IRD, and that is therefore the only share that can "potentially be" funded with the IRD. Under this interpretation, the regulation would not trample on the fiduciary's rights under the instrument. Though the author is fond of this interpretation, she has not found anyone else who shares it.

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-corpus:

A. **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. 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 ¶ 6.4.07.

B. **Fund other shares first.** If the trustee wants to allocate a particular IRD-corpus item to one beneficiary's share, the trustee can distribute all the other assets first, fully funding all the other beneficiaries' shares before withdrawing funds from the plan. Then he is left with only one asset, the retirement plan, which he cashes out. This cash can only be used to fund one beneficiary's share because all other beneficiaries have received their shares in full.

*6.4.07 **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 ¶ 6.4.07 discusses the income tax effects of such a transfer to a specific or residuary legatee. See Form 5.2 (Appendix B) for how to accomplish the transfer. For transfer in fulfilment of a pecuniary bequest, see ¶ 6.4.08.

The general rule is that the transfer of an inherited retirement plan would trigger immediate realization of the income represented by the retirement plan, because it is the transfer of a right to receive IRD. § 691(a)(2); see excerpt from ¶ 2.3.03, Appendix A. 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). Instead, the transferee is taxable on the IRD as and when it is paid to him or her. § 691(a)(1)(C).

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 Warren. 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. § 691(a)(1)(C); Reg. § 1.691(a)-4(b)(2).

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), 9537011, and 2006-52028.

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 Reg. § 1.691(a)-4(b)(3) provides only that the beneficiaries pay the tax if a trust *terminates* and distributes the right-to-receive to the beneficiaries, Professor Jeffrey Pennell points out that a discretionary distribution of principal could be considered a partial termination of the trust and thus fit within the regulation cited.

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.

Note that the IRS often issues rulings approving the transfer of an IRA from an estate to the estate beneficiaries as a nontaxable event without even mentioning § 691(a)(2); see PLRs 2004-52004, 2006-46025, 2006-46027, 2006-46028, 2006-47029, and 2006-47030.

6.4.08 ***Funding pecuniary bequest with right-to-receive IRD***

¶ 6.4.07 dealt with the transfer of a retirement plan, intact, to a trust or estate beneficiary in fulfilment of a *specific or residuary* bequest. In Chief Counsel Memorandum 2006-44020 (12/15/05), 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 [sic] is a disposition for § 691(a)(2) purposes."

See also PLR 2006-08032, in which a trustee transferred shares of an IRA to charities in fulfilment 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.

Is the Chief Counsel correct? The *Kenan* case involved a fiduciary's transfer of appreciated property (not IRD) in fulfilment 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 fulfilment of a pecuniary bequest in 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 transfers $400,000 of the IRA to the marital trust and keeps the rest for the residuary credit shelter trust. In this example, 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 fulfilling the pecuniary marital bequest, and a transfer in fulfillment of a bequest is not taxable under § 691(a)(2). The trust has no choice regarding which asset to use to fund the marital trust—the IRA is the only asset available.

The author's argument on this point is supported by several PLRs which allowed a surviving spouse to roll over benefits that were paid to her through a pecuniary bequest in a will or trust, though those PLRs did not mention § 691(a)(2). See PLRs 9524020, 9608036, 9623056, and 9808043. For more on this, see Choate, N., "Mysteries of IRD," *Tax Management Memorandum*, Vol. 38, No. 20, p. 235 (Tax Management Inc., Washington, D.C., 9/29/97). For planning purposes, however, it is wise to assume that the transfer of retirement benefits out of an estate or a trust to a beneficiary in fulfilment of a pecuniary bequest will trigger immediate realization of income under § 691(a)(2). Accordingly, drafters should avoid the problem; see ¶ 6.5.01, #7.

6.5 Putting it All Together

6.5.01 ***Trust as beneficiary: Checklist***

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

1. Does the client really need 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 you have determined that you will need to name a trust as beneficiary.

2. If any trust provisions deal with retirement benefits, you need to define "retirement benefits." See Form 4.9, Appendix B, which uses different definitions for different purposes.

3. If the trust is intended to qualify for the federal estate tax marital deduction, see ¶ 3.3.01–¶ 3.3.06 (Appendix A) and ¶ 6.1.02(E).

4. If the trust's dispositive terms will distinguish between "income" and "principal," or if the trustee's compensation will be based on specified percentages of income and principal, consider how these terms will apply to the retirement plan and to distributions from it and draft accordingly. ¶ 6.1.02.

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.

6. If the trust is to be divided into shares or subtrusts upon the client's death, see ¶ 6.3.01 regarding whether, if benefits may be allocated only to one 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 3.4 (designation of contingent beneficiary), Appendix B, for an example of how to leave benefits in separate shares directly to separate trusts established under a single trust instrument. 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 beneficiary 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 IRD is a taxable transfer (¶ 6.4.08), 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.

6.5.02 ***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 on or after the Beneficiary Finalization Date. See ¶ 6.2.10(A), (C), and Form 4.2, Appendix B. If there are no assets available to pay debts, expenses, and taxes other than retirement benefits, consider specifying that only certain plans may be used for this purpose, so that only the plans authorized to be used to pay the debts and expenses 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 (and to remove the income tax money from the gross estate for estate tax purposes).

Similarly, include a provision that the trust will be irrevocable at the participant's death (¶ 6.2.06) and that (in determining who are a person's children or issue) certain adult adoptions occurring after the participant's death will be ignored (¶ 6.2.07). See Forms 4.1, 4.3, Appendix B. Beyond these few limited clauses, however, there is no boilerplate provision that can assure that the trust will qualify as a see-through. Qualification depends on the substantive terms of the trust.

6.5.03 ***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 that in that 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 IRS's failure to issue any 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 IRA-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.

6.5.04 ***Should you use a separate trust just for the 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 all the client's other assets, with that all-assets 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 4.7, 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? Can the trustee allocate different assets to the GST-exempt and GST-nonexempt shares within a single trust? Will the trustee, the client, or a later attorney amending the trust recognize the intricate web of how the retirement benefits must be specially treated? But single-trusters pooh-pooh these difficulties as exaggerated or inapplicable.

I take no sides in this dispute, other than suggesting that separate trust treatment is impracticable for smaller retirement plans. Forms in Appendix B use both approaches. See also ¶ 6.3.12 (opening paragraph plus subsections (B), (D), and (G)) and ¶ 6.1.06 for more discussion of when to have separate trusts versus one pooled trust and related questions.

Appendix A

Selected Sections from Other Chapters of *Life and Death Planning for Retirement Benefits*

This handout, "Making Retirement Benefits Payable to Trusts," is an expanded and updated version of Chapter 6 of the author's book *Life and Death Planning for Retirement Benefits* (see Appendix C). This Appendix A contains excerpts from Chapters 1, 2, and 3 of that book. These are needed to make this handout a complete exposition of "Making Retirement Benefits Payable to Trusts" (other than charitable trusts).

FROM CHAPTER 1 of *Life and Death Planning for Retirement Benefits* ("The Minimum Distribution Rules"):

1.6.07 ***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.** The spouse is considered the sole trust beneficiary, for minimum distribution purposes, if she is the sole life beneficiary of a conduit trust that is named as sole beneficiary of the benefits. See ¶ 6.3.05.

As previewed by Rev. Rul. 2000-2, 2000-1 C.B. 305, the delayed Required Commencement Date of § 401(a)(9)(B)(iv) (the spouse is not required to commence distributions as beneficiary until the later of the end of the year after the year of the participant's death or the year the participant would have reached age 70½; ¶ 1.6.04) for MRDs (if the participant died before his RBD), and related rules (i.e., the rule that the surviving spouse is treated as the "participant" for purposes of applying the MRD rules her death if both spouses die young; ¶ 1.6.05) (but see ¶ 6.3.14(A), last paragraph), apply in this case, as does the special method of computing the spouse's life expectancy (spouse's life expectancy is recalculated annually, whereas other beneficiaries must use the fixed-term or reduce-by-one method; ¶ 1.6.06(D)). Reg. § 1.401(a)(9)-5, A-5(c)(2).

However, for purposes of the spouse's right to elect to treat an inherited IRA as her own IRA, 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 surviving spouse named individually as beneficiary can exercise. For the spouse's ability, in some cases, to use a rollover through the trust to accomplish the same goal by other means, see ¶ 3.2.08 of *Life and Death Planning for Retirement Benefits* or the *Special Report: Estate Administrator's Guide to Retirement Benefits* (Appendix C).

B. **Spouse is sole beneficiary: grantor trust.** If the spouse is treated as owner of all of the trust property under the grantor trust rules (¶ 6.3.08), she *should* be considered the sole beneficiary of that trust and the trust should be entitled to the same privileges as the spouse

individually (other than the spousal rollover and the spousal election to treat an inherited IRA as the spouse's own IRA). See "A" for a list of these privileges. Unfortunately, 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 ("B"), *or* (ii) whatever amounts are distributed from the retirement plan to the trust during her lifetime ("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*. Thus, the delayed Required Commencement Date (and related rules) of § 401(a)(9)(B)(iv) (¶ 1.6.04–¶ 1.6.05) do *not* apply to benefits payable to such a trust. The special method of computing the spouse's life expectancy (¶ 1.6.06(D)) does *not* apply; the life expectancy of the oldest trust beneficiary is calculated on a fixed-term basis as described at ¶ 1.5.05.

D. **Lifetime distributions.** Required *lifetime* distributions to a participant who has named a trust as his sole beneficiary are determined under the Joint and Last Survivor Table or the Uniform Lifetime Table, whichever produces a lower MRD in any particular distribution year, if the trust is either a conduit trust for his spouse, or (presumably) a 100 percent grantor trust for the benefit of his spouse, provided the participant complies with the documentation requirement (¶ 6.2.08) and other trust rules (¶ 6.2.03). A participant who has named a QTIP trust as beneficiary must use the Uniform Lifetime Table.

FROM CHAPTER 2 of *Life and Death Planning for Retirement Benefits* ("Income Tax Issues"):

2.3.01 ***Definition of IRD; why it is taxable***

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. A death benefit under a deferred annuity (Rev. Rul. 2005-30, 2005-20 I.R.B. 1015) or variable annuity (PLR 2000-41018) contract is IRD.

Normally, an individual who inherits property gets a new income tax basis in the property, equal to the value of the property as of the date of death (or other date used to value the decedent's property for estate tax purposes). § 1014(a). The new basis is usually referred to as a stepped-up basis, on the assumption that the property appreciated between the time the decedent acquired it and the date of death.

However, "property which constitutes a right to receive an item of income in respect of a decedent" is an exception: IRD does not get a new basis at death. § 1014(c). Instead, an individual who inherits IRD takes over the decedent's basis (carryover basis).

After 2009, § 1014 is repealed and carryover basis will apply generally to all assets. …

2.3.02 ***When and to whom IRD is taxed***

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). …

Bill Example: Bill names Ted as beneficiary of his 401(k) plan. Ted withdraws money from the plan after Bill's death. The withdrawal is includible in Ted's gross income as IRD. § 691(a)(1)(B).…

2.3.03 ***Tax on transfer of right-to-receive IRD***

…There is another occasion which 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. …

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 is usually *not* taxable under § 691(a)(2); see ¶ 6.4.07. For exception, see ¶ 6.4.08.

Rev. Rul. 85-13, 1985-1 C.B. 184, established that transactions between an individual and trust all of whose assets are deemed owned by such individual under the "grantor trust rules" (see ¶ 6.3.08) 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). Assuming that the assignor-beneficiary is also the only permissible recipient of payments from the trust during his/her lifetime, the account should retain its status as an IRA following the transfer. PLRs 2006-20025 and 2008-26008 confirmed this proposition.

2.3.04 ***Income tax deduction for estate tax on IRD***

The beneficiary gets an income tax deduction for federal estate tax paid on IRD he receives. § 691(c). To determine the amount of the deduction, first determine the estate tax due on the entire

estate. Next, determine the net value of all items of IRD that were includible in the estate (for definition see § 691(c)(2)(B)). The estate tax attributable to the IRD is the difference between the actual federal estate tax due on the estate, and the federal estate tax that would have been due had the net value of the IRD had been excluded from the estate.…

2.3.05 ***Who gets the § 691(c) deduction***

The § 691(c) deduction goes to the person who receives the IRD, not the person who paid the estate tax. If there are several beneficiaries who receive the IRD, the deduction is apportioned among them in proportion to the amount of IRD each received. § 691(c)(1)(A).…

FROM CHAPTER 3 of *Life and Death Planning for Retirement Benefits* ("Marital Matters"):

3.3.02 ***Drawbacks of trust for spouse compared with spousal rollover***

Leaving retirement benefits to a trust for the benefit of the surviving spouse (whether it's a "QTIP" or credit shelter/bypass trust) is no tax bargain compared with leaving such benefits outright to the surviving spouse, if the surviving spouse rolls over the inherited benefits to his or her own IRA. Making benefits payable to a trust for the spouse, as opposed to the spouse individually, often results in forced distribution of the benefits sooner, and payment of income taxes at a higher rate, than would be the case if the spouse personally were named as beneficiary.

If the trust named as beneficiary 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 (typically the spouse is the oldest beneficiary). But distributing the benefits over the single life expectancy of the surviving spouse 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. Distribution over the spouse's life expectancy guarantees that the benefits will be entirely distributed out of the plan by the time the spouse reaches (or would have reached) her late 80s. (Slightly better deferral can be obtained with a conduit marital trust; see ¶ 6.3.14.)

In contrast, if benefits are left to the spouse outright and rolled over to her own plan, and she withdraws only the MRDs required under the Uniform Lifetime Table, the benefits are guaranteed to outlive the spouse; in fact they will probably be worth more, when she reaches her late 80s, than they were worth when she inherited the plan!

Also, benefits paid to the trust and not distributed to the spouse will generally be taxed at the trust's rate, which is generally higher than most individuals' tax rates; see ¶ 6.4.01. In contrast, benefits the spouse withdraws from his/her rollover IRA will be taxed at the spouse's individual rate.

BENEFITS PAID TO A MARITAL TRUST: QUALIFYING FOR THE MARITAL DEDUCTION

The following is a description (excerpted from Chapter 3 of *Life and Death Planning for Retirement Benefits*) of the requirements that must be met to obtain the federal estate tax marital deduction for retirement benefits that are payable to a trust for the benefit of the participant's surviving spouse, where the surviving spouse is a U.S. citizen.

3.3.01 ***Leaving benefits to…marital trust: Overview***

…You must cover three points when leaving retirement benefits to a trust if you want the benefits to qualify for the federal estate tax marital deduction.

First, generally, no deduction is allowed for a "terminable interest" left to the surviving spouse. § 2056(b)(1). You need to understand the IRS's concept of how the "terminable interest rule" applies to retirement benefits payable to a marital trust; see ¶ 3.3.03.

Second, to qualify for the marital deduction, a trust must generally provide (among other things) that the spouse is entitled for life to all income of that trust. § 2056(b)(7). You need to assure that the "income of the retirement plan" is determined correctly for marital deduction purposes; see ¶ 6.1.02(E).

Third, you must make sure the spouse is "entitled" to all that income; see ¶ 3.3.05–¶ 3.3.06.…

3.3.03 ***IRS regards benefits, trust, as a 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 positions 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, 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.** 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.

To accommodate the IRS position, it is advisable to specify in the 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. There are two ways to accomplish that. One is to specify that the trustee must pay to the spouse, at least annually, the income of the retirement plan; see Form 4.4.01, Appendix B. The other is to use the standard marital trust language (that the trustee must pay the spouse the income of the trust), but specify that the trustee must withdraw, annually, all income of the retirement plan; this makes it clear that the trust income the spouse is entitled to includes the retirement plan income. See Form 4.4.02, Appendix B. Either way, it's helpful to define what the "income" of the retirement plan means; see ¶ 6.1.02 and Form 4.5, Appendix B.…

3.3.05 ***The "entitled" requirement; income vs. MRD***

We now turn from the "income" aspect to the "entitled" aspect of the requirement that the spouse must be "entitled for life to all of the income" of a marital trust. This ¶ 3.3.05 discusses the general problems of meeting this requirement in connection with retirement benefits payable to a marital trust, and how this requirement relates to the minimum distribution requirement. Particular methods of compliance with the "entitled" requirement are discussed in ¶ 3.3.06–¶ 3.3.08.

Regardless of whether the trustee is required to withdraw "income" from the retirement plan, the trustee must withdraw the minimum required distribution (MRD) annually. Thus, if the trust instrument requires the trustee to withdraw the "income" annually, what it is really requiring is that the trustee withdraw from the retirement plan each year the income or the MRD, whichever is the larger amount; see PLR 2005-22012 for an example of a marital trust that specified the trustee had to withdraw the greater of the two amounts. The trustee must calculate both amounts each year in any case. The MRD may be more or less than the income. The spouse is entitled to the "income," but the marital deduction rules do not require that she receive the entire MRD (if that is larger than the income). …

3.3.06 ***Distribute all income to spouse annually***

The simplest (and recommended) 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. Reg. § 20.2056(b)-5(f)(8). This method was first blessed by the IRS in Rev. Rul. 89-89, 1989-2 C.B. 231, and is believed to be the approach most commonly used by estate planners. See, *e.g.*, PLRs 9321035, 9321059, 9418026, and 9348025. See Forms 4.4.01, 4.4.02, Appendix B. Unless the "income" substantially exceeds the MRD, this method does not have significant tax drawbacks (beyond the usual drawbacks of leaving retirement benefits to a marital trust in the first place; see ¶ 3.3.02).…

[For other more complex methods of complying with the "entitled to all income" requirement, see ¶ 3.3.07–¶ 3.3.10 of *Life and Death Planning for Retirement Benefits*, or of the *Special Report: Retirement Benefits and the Marital Deduction (Including Planning for the Noncitizen Spouse)*; see Appendix C regarding both publications.]

Appendix B

Selected Forms from Appendix B of *Life and Death Planning for Retirement Benefits*

Why No Complete Trust Forms?

This Appendix contains sample clauses 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 ¶ 6.5.01, #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, [SPOUSE NAME], 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; provided, however, that if any Contingent Beneficiary is under the age of 30 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 established or to be established for such Beneficiary's benefit under Article [NUMBER] of the [TRUST NAME] Trust, dated [TRUST DATE] [optional:, 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

Definitions of capitalized terms are in Form 4.9. Use Form 4.9 (modified as necessary to delete unneeded definitions) when using any Form that contains defined (capitalized) terms.

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 also ¶ 6.3.01(D).

Note: Using this form will not automatically "cure" all potential problems with having a nonindividual trust beneficiary. If the substantive terms of the trust make payments to a nonindividual beneficiary unavoidable, then including this boilerplate clause will make the trust document nonsensical. For example, if the substantive terms of the trust are "Pay income to my wife for life and on her death pay the principal to Charity X," and the trust also includes the following paragraph, and the only asset of the trust is an IRA, the trust will be defective, because essentially it provides no remainder beneficiary for the IRA asset. The following paragraph "works" only to prevent use of the benefits to pay off nonindividual beneficiaries who are entitled to a share of the trust at the time of the participant's death. If there are charitable or other nonindividual beneficiaries who are to benefit under the trust at some LATER time (such as after the death of the life beneficiary), do not use this provision.

Notwithstanding any other provision hereof, except as provided in this paragraph, 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 shall be established by IRS regulations or other guidance 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"), distribute to or for the benefit of my estate, any charity, or any other nonindividual beneficiary any Deferrable Retirement Benefit. It is my intent that all 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 § 401(a)(9) of the Code. Accordingly I direct that no Deferrable Retirement Benefit may 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 that 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).

Notwithstanding any other provision hereof or of state law, a person's "issue" shall not include an individual who is such person's "issue" by virtue of legal adoption if such individual

(1) was so adopted after my death and (2) is older than the oldest other beneficiary of this trust who was a living member of said class at my death.

4.4.01 Marital Deduction Savings Language: Option 1. See ¶ 3.3.03.

The Trustee shall pay the net income of the trust to my spouse at least as often as annually, as long as my spouse lives. If any marital trust created by this instrument becomes the beneficiary of any Retirement Benefit, the "net income of the trust" to which my spouse is entitled under the preceding sentence shall include the net income of such Retirement Benefit.

4.4.02 Marital Deduction Savings Language: Option 2. See ¶ 3.3.03.

If any marital trust created by this instrument becomes the beneficiary of any Retirement Benefit, the Trustee must withdraw from such marital trust's share of such Retirement Benefit, each year, at least whichever of the following amounts is the greater: A. the net income of the marital trust's share of such Retirement Benefit for such year; or B. the Minimum Required Distribution for such year with respect to such Retirement Benefit. 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 greater of the said amounts.

4.5 Accounting for Retirement Benefits. See ¶ 6.1.03.

.01 General Principles. This Article shall govern the Trustee's accounting for Retirement Benefits. In general, a Retirement Benefit shall be deemed an asset of the Trust, increases or decreases in its value shall be allocated to income or principal of the Trust as provided herein, and distributions from the Retirement Benefit shall be accounted for as provided herein.

.02 Certain Individual Account Plans. With respect to any Retirement Benefit which is an individual account plan, for which the Trustee receives such reporting with respect to the plan's assets that the Trustee can readily determine the "income" and "principal" of the Trust's interest in the plan in accordance with traditional principles of income and principal, the Trustee shall account for the Trust's interest in the Retirement Benefit as if the applicable plan assets were owned by the Trust directly.

.03 All Other Retirement Benefits. With respect to any other Retirement Benefit, the Trustee shall treat the inventory value of the trust's interest in the Retirement Benefit as principal, and allocate any subsequent increases in value (or charge decreases in value) in such interest to income or principal in accordance with any reasonable method selected by the Trustee that is consistent with traditional principles of income and principal and is consistently applied to the Trust's interest in such plan, including:

(A) A method specified in any Uniform Principal and Income Act (UPIA) or other state law governing trust accounting for retirement benefits or deferred compensation, but only if such law provides for a reasonable apportionment, each year, between the income and remainder beneficiaries of the total return of the trust for such year. The "10 percent rule" of UPIA Section 409(c), or any

other state law that determines income with respect to a Retirement Benefit by reference to the amount of the retirement plan's required or nonrequired distributions rather than by reference to the return on the applicable investments or other traditional principles of income and principal, or that otherwise departs fundamentally from traditional principles of income and principal, may not be used to determine "income" for any purpose of this trust.

(B) In the case of a plan similar to the type of plan specified in paragraph .02 above, the method specified in said paragraph .02 adapted as necessary.

(C) Any method used in the Code or Treasury regulations to distinguish between "ordinary income" and "return of principal" (or corpus) with respect to similar assets.

.04 Treatment of Distributions. When a distribution is received from or under a Retirement Benefit, and, at the time of such distribution, under the foregoing rules, the trust's interest in the Retirement Benefit is composed of both income and principal, such distributions shall be deemed withdrawn first from the income portion.

.05 Definition of Inventory Value. In the interpretation of this Article, the "inventory value" of an interest in a Retirement Benefit shall mean:

A. In the case of an interest that becomes payable to (or is owned by) this trust as of the date of my death, its "fair market value" determined in accordance with the rules applicable for valuing such interests for purposes of the federal estate tax (as in effect at my death, or, if such tax does not then exist, as last in effect); or,

B. In the case of an interest that becomes payable to this trust as of a date after the date of my death (for example, by transfer from another fiduciary), its "fair market value" shall be its value as of my death determined as provided in the preceding subparagraph, adjusted as necessary for distributions, expenditures, and receipts that occurred between the date of my death and the date of transfer to this trust; or, if the trustee cannot determine its value in that manner, its "fair market value" shall be its value as of the date it becomes an asset of this trust, determined as provided in the preceding subparagraph, provided, in the case of an interest transferred to this Trust from another fiduciary (such as my Personal Representative) accrued income so transferred shall be treated as income and shall not be included in "inventory value."

4.6 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 sole 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 all remaining property of this trust shall be paid to [HERE SPECIFY THE REMAINDER BENEFICIARY; INSERT NAME OF INDIVIDUAL, TRUST, OR OTHER ENTITY TO WHICH THE ASSETS WILL PASS ON DEATH OF THE "CONDUIT" BENEFICIARY, OR SPECIFY ONGOING TRUST TERMS IF THE TRUST IS TO CONTINUE IN FORCE].

4.7 Conduit Provision Included in "Family Pot" Trust

See ¶ 6.3.12(B). As a reminder, this approach will not work for a trust that is not established until the death of a prior beneficiary; see ¶ 6.3.10(A). This approach works only for benefits that pass to the Family Trust on the death of the participant.

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] 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 as provided in Paragraph C.

B. 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 sole discretion. The Trustee shall distribute each amount so withdrawn (net of expenses properly charged thereto) 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.

C. With respect to all other property of the trust, the Trustee shall pay such amounts of the income and/or principal of such property 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.

D. At such time as there is no child of mine living who is under the age of [AGE] 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].

4.8 Conduit Trusts to Avoid GST Problem. See ¶ 6.3.15.

Article [NUMBER]

Provision for Deferrable Retirement Benefits

[modify this paragraph if there is no spouse]

Notwithstanding any other provision hereof, this Article shall apply, if my spouse does not survive me, to any Deferrable Retirement Benefit that is payable at my death to this trust, any share of this trust, or any separate trust established under this instrument. If my spouse does survive me,

this Article shall apply, notwithstanding any other provision hereof, to any Deferrable Retirement Benefit that is payable at my death to this trust, any share of this trust, or any separate trust established under this Instrument if and only if my spouse, as of the date of my death, is not a beneficiary of this trust (for example, as a result of a qualified disclaimer(s)).

A. Establishment of Separate Share Benefits Trusts

Article [NUMBER] requires creation of separate trusts or shares (the "Share Trusts") for each of my children then living (and the issue of any deceased child). If, as of the date of my death, the value of Deferrable Retirement Benefits payable to all the Share Trusts, collectively, exceeds [INSERT MINIMUM DOLLAR AMOUNT OF BENEFITS REQUIRED TO MAKE ESTABLISHMENT OF SEPARATE TRUSTS WORTHWHILE, SUCH AS $500,000], then, rather than being added to such Share Trusts, the portion of Deferrable Retirement Benefits payable to each such Share Trust shall instead be held in a separate trust (the "Separate Share Benefits Trust") for the benefit of the beneficiary of such Share Trust. The Separate Share Benefits Trust for each beneficiary shall be held on all the same terms and conditions as those of the Share Trust for the same beneficiary, with the following exceptions:

B. Separate Share Benefits Trust for Child

In the case of a Separate Share Benefits Trust held for the benefit of a Child of mine, Article [NUMBER], Section [NUMBER] [*i.e., the article dictating terms for administering such share during the child's life*], shall not apply, and shall instead be replaced by the following new Article [NUMBER], Section [NUMBER]:

"([NUMBER]) Distributions During Life of My Child:

Each year, beginning with the year of my death, and continuing so long as such Child is living, my Trustees shall withdraw from any Deferrable Retirement Benefit payable to such Trust the Minimum Required Distribution for such Trust's share of such Benefit for such year, plus such additional amount or amounts, if any, as my Trustees deem advisable in their sole discretion. All amounts so withdrawn (net of applicable expenses) shall be distributed to (or applied for the benefit of) such Child as soon as reasonably practicable."

C. Separate Share Benefits Trust: Deceased Child's Issue

In the case of a Separate Share Benefits Trust held for the benefit of a descendant of a deceased child of mine, Article [NUMBER], Section [NUMBER] [*i.e., the article dictating terms for administering the share of issue of a deceased child*], shall not apply, and shall instead be replaced by the following new Article [NUMBER], Section [NUMBER]:

"([NUMBER]) Distributions During Life of Beneficiary:

Each year, beginning with the year of my death, and continuing so long as the beneficiary of such Separate Share Benefits Trust (the "Beneficiary") is living, my Trustees shall withdraw from any Deferrable Retirement Benefit payable to such Trust the Minimum Required Distribution for such Trust's share of such Benefit for such year, plus such additional amount or amounts, if any, as

my Trustees deem advisable in their sole discretion. All amounts so withdrawn (net of applicable expenses) shall be distributed to (or applied for the benefit of) such Beneficiary as soon as reasonably practicable."

4.9 Definitions for Trust Forms

This Form is designed to be used with Form 4.2 and Forms 4.4–4.8. The optional definition of Taxable Retirement Benefits can be deleted; it is not used with any of the Forms in this Appendix. That definition is included here as an example of a definition that could be used if the trust instrument directs that taxable benefits are to be used to fund particular shares, such as a marital trust or a charitable bequest.

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. A "**Deferrable Retirement Benefit**" means any Retirement Benefit that meets the following two requirements: First, it is subject to the Minimum Distribution Rules. Second, the terms of the plan or arrangement that governs such Benefit permit a trust that is named as beneficiary of such Benefit to take distribution of such Benefit in annual instalments over the life expectancy of the oldest trust beneficiary, either by taking such distributions directly from such plan or by transferring the benefits from such plan to an "inherited IRA" payable to this trust under § 402(c)(11)(A). 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. [optional additional definition] A "**Taxable Retirement Benefit**" is any Retirement Benefit other than a Roth IRA, deemed Roth IRA, or designated Roth account within the meaning of § 408A or § 402A of the Code.

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

4. The "**Minimum Required Distribution**" for any year means, for each 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 lesser or greater amount (if any) 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 (a) the amount that was required to be distributed to me with respect to such Benefit during such year under the Minimum Distribution Rules, minus (b) amounts actually distributed to me with respect to such Benefit during such year.

5. The terms "**life expectancy**," "**Applicable Distribution Period**," and "**designated beneficiary**" shall have the same meaning as under the Minimum Distribution Rules.

5.2 Fiduciary Letter Transferring Plan Account to Beneficiary

See ¶ 6.1.05. Use either Alt. 1 or Alt. 2, plus either Alt. A or Alt. B.

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

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

I am the [FIDUCIARY’S 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” or “APPLICABLE INTESTACY LAW”].

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

I am the Trustee of the [NAME OF TRUST] (“the Trust”) which is 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. A: 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].” The beneficiary’s address and Social Security number are [INSERT].

[Alt. B: Transfer to several beneficiaries, in separated accounts]

Accordingly, I hereby instruct and direct you to divide the benefit into [NUMBER OF SEPARATED ACCOUNTS TO BE ESTABLISHED] separate accounts of equal value, 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 to be treated as 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 required to complete this transfer.

Very truly yours,

[SIGNATURE OF EXECUTOR OR TRUSTEE]

Appendix C

Bibliography & Resources

RESOURCES, CHOATE PUBLICATIONS:

The following other publications by Natalie B. Choate are cited in this handout:

The **book** *Life and Death Planning for Retirement Benefits* (Ataxplan Publications; 6th ed. 2006) may be purchased for $89.95 plus shipping by calling 800-247-6553, or through the author's website www.ataxplan.com.

The **Special Reports** cited in the following paragraphs can be purchased and downloaded at www.ataxplan.com:

For more information about the **minimum distribution rules**, see Chapter 10 (for defined benefit plans) and Chapter 1 (for all other plans) of *Life and Death Planning for Retirement Benefits*, or see the *Special Report: Tax Pro's Guide to the Minimum Distribution Rules*. ¶ 1.5 of both those publications covers the post-death rules in particular.

For more information about how to qualify retirement benefits for the **estate tax marital deduction** in the case of a surviving spouse who is a U.S. citizen, see Chapter 3 (¶ 3.3) of *Life and Death Planning for Retirement Benefits* or (for both citizen and noncitizen spouses) see the *Special Report: Retirement Benefits and the Marital Deduction (Including Planning for the Noncitizen Spouse)*.

The *Special Report: Estate Administrator's Guide to Retirement Benefits* provides more detail regarding past IRS PLRs approving the **transfer of an inherited retirement plan** or IRA out of the trust or estate named as beneficiary to the beneficiaries of the trust or estate, and about spousal rollovers "through" a trust or estate. See this *Special Report* also for rulings dealing with **reformation** of a trust instrument after the participant's death for purposes of improving the income tax or minimum distribution results.

For more information about making retirement benefits payable to a **charity**, charitable remainder trust, or other charitable entity, see Chapter 7 of *Life and Death Planning for Retirement Benefits* or the *Special Report: Charitable Giving with Retirement Benefits*. See ¶ 7.4.01 of the book or Special Report for income tax considerations in connection with a trust's distributions to charity; ¶ 7.4.04 for computation of the income tax charitable deduction for a trust or estate; ¶ 7.5.05(C) for the IRD deduction in connection with retirement benefits paid to a charitable remainder trusts.

RESOURCES, FORMS:

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 the following two sources, both of which offer complete systems of sophisticated estate planning document forms for the practicing attorney:

"**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."

"**WealthDocs**," from WealthCounsel, LLC (http://www.wealthcounsel.com/wealthdocs.aspx). "A complete document creation system for Wills, Revocable Living Trusts, ILITs, CRTs, FLPs, and Special Needs Trusts. Ancillary and supporting documents to help you manage every aspect of your practice, from invoices and agreement letters to funding documents, plus much more." They have a strong educational program as well.

BIBLIOGRAPHY:

For **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*, 15th Ed. (2007), Practicing Law Institute, 810 Seventh Ave., New York, NY 10019, www.pli.edu; Ferguson, M. Carr, Freeland, James L., and Ascher, Mark L., *Federal Income Taxation of Estates, Trusts, & Beneficiaries*, CCH/Wolters Kluwer (3rd 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*").

The problem of **trust accounting for retirement benefits** is the subject of the following two 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).

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

The best book for lawyers on **tax-oriented estate planning** is *Estate Planning Law and Taxation* (4th ed., 2002–2003, with 2005 Supplement) by Professor David Westfall and George P. Mair, Esq., published by Warren, Gorham & Lamont (RIA), Boston. Obtain the paperback "Financial Professionals' Edition." This book covers the generation skipping transfer (GST) tax among many other subjects.