Pitfalls and Opportunities

in

Distributing Retirement Assets to Trusts

"Watch it, now. Watch it. Watch it. It's gonna get you."

"Wooly Bully," by Sam the Sham and the Pharaohs

Ground Rules:

1. In order to be able to "stretch out" the Minimum Required Distributions ("MRDs"), there must be one or more **"Designated Beneficiaries."**

2. We're trying to create a **"See-Through Trust."** A See-Through Trust is one that is ignored for purposes of determining the Designated Beneficiaries. Another type of trust that allows the beneficiary to be considered as a Designated Beneficiary is a "Conduit Trust," which will not be discussed in this outline. **See Choate, "Life and Death Planning for Retirement Benefits, 7th ed., 2011" herein cited as "Choate," pp. 413-414. This excellent reference work is available at Natalie Choate's web site: www.ataxplan.com**

3. A trust, as such, can't be a Designated Beneficiary. **Designated Beneficiaries must be identifiable individuals.**

4. Prior to October 31 of the year after the participant's death, the trustee must provide the plan administrator with a **copy of the trust document** and a **"final list" of all of the trust's beneficiaries**.

How to Designate Shares for Children

Ajax has two children. Bjax and Cjax, ages 20 and 23, by his first wife, He has 1 yr. old Djax by his second wife. His IRA is payable to the trustee of his revocable trust which provides that the trust assets be divided into shares, with one share for each of Bjax, Cjax and Djax. The trust meets the "See Through" criteria. **? Is this a good plan ?**

No, it's a poor plan. Here's why. The Regulations provide that, if a retirement plan is divided into "separate accounts," the MRDs will be calculated separately for each account. Regs. §1.401(a)(9)-8; A-2(a)(2). Although the trust document provides for separate shares, because the beneficiary designation does not, the MRDs for each of the children's shares will be based on the life expectancy of Bjax. Djax will lose over 20 years of "stretch." **Choate, p. 429 at "C"**.

The right way. Suppose that the beneficiary designation had language similar to:

> "I direct that, at my death, my IRA be divided into separate accounts, with one account for each of Bjax, Cjax and Djax who survive me. I designate the separate trusts for each of them under the provisions of the Ajax Revocable Trust, u/a dated [date] as the beneficiaries of those separate accounts."

By creating the separate shares in the beneficiary designation, as well as in the trust document, each child's MRDs will be determined using his or her age. See, e.g., PLR 200607031.

The Problem with QTIPs.

The best way to leave a retirement plan to a spouse is to just leave it to her – outright. She can do a "spousal rollover" to an existing plan or treat an inherited IRA as her own IRA. In either case, she need not take MRDs until her normal Required Beginning Date.

What about our friend, Ajax? He wants to obtain a marital deduction for assets that he leaves to his wife, but is concerned about her leaving his older children out in the cold. The answer is: "create a QTIP Trust".

The QTIP rules require that spouse be entitled to all "income," distributed at least annually. Suppose that the only asset of the trust is an IRA. **Does a direction to pay out all of the "income" comply with the QTIP rules? Unless we do more, the answer is "No."**

The reason is that the word "income" in the QTIP rules means "trust accounting income," not taxable income. MRDs are taxable income, but are trust accounting principal., with the exception of the "10% rule" in the Revised Principal and Income Act. The Connecticut Statute provides in part:

> **Sec. 45a-542q. Deferred compensation, annuities and similar payments.**
>
> (a) In this section, "payment" [includes]… an individual retirement account and a pension, profit-sharing, stock-bonus or stock-ownership plan…..
>
> (b) If no part of a payment is characterized as interest, a dividend or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income ten per cent of the part that is required to be made during the accounting period and the balance to principal….

(c) If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction…."

Do NOT rely on this Statute. It may not work. In Rev. Rul. 2006-26, I.R.B. 2006-22, the Service held that this attempted legislative fix "does not satisfy the requirements of §§ 20.2056(b)-(f)(1) and 1.643(b)-1 because the amount of the …MRD is not based on the total return of the IRA…."

How to do it.

In Rev. Rul. 2000-2, 2000-1 C.B. 305, a trust holding an IRA qualified as QTIP where the surviving spouse could compel the trustee to withdraw from the IRA an amount equal to the income of the IRA for the year and distribute that income to her. There are, however, other requirements.

The trust language in Rev. Rul. 2006-26, *supra*, is instructive. It contains all of the elements of a qualifying QTIP under Rev. Rul. 2000-2 and more. Consider the fact that a QTIP is designed to preserve the trust assets for distribution to the remaindermen.

1. As in Rev. Rul. 2000-2, the beneficiary has the power, exercisable annually, to compel the trustee to withdraw an amount equal to the "internal" IRA income. If she exercises the power, the trustee must withdraw the greater of the income or the MRD from the IRA and distribute the income to her.

2. Any income in excess of the MRD is added to the trust's principal.

3. If the spouse does not exercise her withdrawal right, the trustee need only withdraw the MRD.

NOTE: The Executor <u>must</u> elect QTIP for <u>both</u> the trust and the retirement plan.

WATCH OUT for "April and October Marriages. MRDs are based on the age of the oldest trust beneficiary. If the remaindermen (most often the Settlor's children) are older than the surviving spouse, then the oldest one will be the measuring life for purposes of determining the MRDs.

Drafting tip:

Following is some sample language which satisifies the requirements in the Revenue Rulings:

> **<u>2. Distribution from Retirement Accounts</u>.**
>
> **<u>a. Generally</u>.** If the Trust is the beneficiary of any Individual Retirement Account, pension, profit sharing, 401(k), 403(b), or similar retirement account (the 'Account'), then the Trustees shall direct that the balance of the Account as of the date of the Settlor's death be distributed to the Trust in the amounts required from time to time under the method of distribution for the Account for purposes of Section 401(a)(9) of the United States Internal Revenue Code of 1986, or under any amendatory or supplemental provision of Federal tax law, plus any annual payments, if any, as required under paragraph b. of this Subsection 2.
>
> **<u>b. Additional Annual Payments</u>.** Notwithstanding that the Account shall be allocated to principal for Trust accounting purposes, the Trustees shall allocate to income, and distribute to BENEFICIARY in accordance with the provisions of Subsection 1 of this Section A, that portion of each annual installment payment from the Account (or if distributions are received more frequently than annually, that portion of all distributions made during the annual period) equal to the income earned by the Account for the applicable annual period. If distributions from the Account for any annual period total less than the income earned by the Account for that annual period, the Trustees shall demand additional distributions from the Account so that all distributions for that annual period equal at least to the

income earned by the Account for that annual period. BENEFICIARY shall have the sole power, in her discretion, to compel the Trustees to demand those distributions. Other distributions from the Account shall be allocated to principal.

If any assets of the Account shall not, in BENEFICIARY'S determination, be productive of a reasonable rate of income, she is authorized to require the Trustees to convert those assets into other assets which will be productive of a reasonable rate of income by delivering to the Trustees an acknowledged instrument, designating those assets which she has determined to be unproductive. Within a reasonable time after receipt of that instrument, the Trustees shall convert the designated assets into other assets which will be productive of a reasonable rate of income.

Eliminating a Disqualifying Beneficiary.

Recall that, in order for a trust to qualify as a "See-Through Trust," all of the beneficiaries have to be individuals. Consider the following scenario:

Papa dies survived by his two daughters, Lola, age 23 and Lula, age 20. He left his retirement plan to a trust which provides that 5% of the value of the trust assets be distributed to the Fund for Underpaid Lawyers and the balance to Lola and Lula, outright. There is nothing in the trust document that requires the charitable distribution to be made from non-retirement assets.

Because the charity's share could have been satisfied from the retirement plan, there is no Designated Beneficiary. Lola and Lula cannot stretch out their MRDs.

The Regulations provide that: "The employee'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." §1.401(a)(9)-4, A-4(a). We're going to call this date the "Determination Date.

Beneficiaries who are eliminated prior to the Determination Date are not counted. If the charity's distribution were satisfied with non-retirement assets prior to the "next September 30th" deadline, the charity is ignored. Lola's and Lula's MRDs would be determined based on their ages.

What to do. The trustee should satisfy the distribution to the Fund for Underpaid Lawyers before the Determination Date. We underpaid lawyers would be grateful.

Eliminating contingent interests.

The facts are the same as in the 3d Story, except that each of Lola's and Lula's shares are held in trust for them until they reach age 30. If one of them dies prior to age 30, her share will pass to her children or, alternatively to her sister or her sister's children.

The trust agreement provides that, if Lola and Lula both die before age 30 unsurvived by children, the assets pass to their 55-59 year old uncles and aunts and to a church.

One would think that, for purposes of computing the MRDs, the remote contingent interests would be ignored. **Wrong.**

The general rubric is that all potential beneficiaries must be counted to determine whether all beneficiaries are individuals and which one is the oldest.

The Regulations provide that a potential beneficiary will not be counted:

> "merely because the person could become the successor to the interest of one of the [account owner'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 [account owner's] benefit beyond being a mere potential successor to the interest of one of the [account owner's] beneficiaries upon the beneficiary's death" Regs. §1.401(a)(9)-5, A-7(c).

On its face, this Regulation would seem clear. The older beneficiaries only take if they survive Lola, Lula and their as yet unborn issue. **But no. That's not the way the Service looks at it.** They appear to only "bless" trusts where a living beneficiary will take a remainder interest outright. For example, in PLR 200438044, the IRS ruled that a similar trust qualified as a "see-through" trust. However, the children had already reached the distribution age at the time of the account owner's death.

What we did.

In the real "Lula and Lola" example, all of the contingent beneficiaries disclaimed their interests. This was our only option because there was no "saving provision" in the document.

Drafting tip. If you are inserting an "atom bomb" provision, consider exempting all retirement plan assets. For example, you might provide:

"If, at any time, any assets of any Trust are undistributable because no beneficiaries of that Trust are living, the Trustee shall distribute those assets, **with the exception of any Retirement Assets**, as follows: [insert disposition].

Additional "Determination Date" issue and Drafting Suggestion:

The "Number 3" Stories deal with "fixes" before the Determination Date. It is also important to make sure that no taxes, expenses or bequests can be paid from retirement plan assets after the Determination Date. Language similar to the following may be helpful.

Restriction on Retirement Plan Assets.

1. Designation Date.

The "Designation Date" shall be September 30 of the calendar year following the calendar year of the Settlor's death, or on or after any other date which shall be established by the Internal Revenue Service Regulations or other guidance as the final date for determining whether the Trust meets the requirements for treatment of the Trust's beneficiaries as if they had been named directly as beneficiaries of any Retirement Plan payable to the Trust.

2. Prohibition Against Payment.

Notwithstanding any other provision of this Agreement, and except as provided in this Section D., the Trustees may not, on or after the Determination Date, distribute to or for the benefit of the Settlor's estate, any charity or any other non-individual beneficiary any Retirement Plan assets payable to the Trust which is subject to the "minimum distribution" rules of Section 401(a)(9) of the United States Internal Revenue Code of 1986 (the "Code") or of any amendatory or supplemental legislation having similar provisions.

3. Intention and Direction.

It is the Settlor's specific intention that all Retirement Plan assets held by or payable to the Trust on or after the Designation Date be distributed to or held for only individual

> beneficiaries within the meaning of Section 409(a)(9) of the Code and applicable Regulations. Accordingly, the Settlor directs that those Retirement Plan assets may not be used or applied on or after the Designation Date for payment of the Settlor's debts, taxes, expenses of administration or other claims against the Settlor's estate, nor for payment of estate taxes. This Section D. shall not apply to any distribution which is specifically directed by other provisions of this Agreement to be funded."

Don't pay tax on distributions to charity

Ellsworth created a revocable trust with percentage shares distributable to charitable and non-charitable beneficiaries. One of the charities' shares was approximately $460,000. Ellsworth left an IRA of $260,000 to the trust.

The trust agreement had no provision for allocating specific assets to the charities. If paid to the trustee, the IRA would be part of the trust's Distributable Net Income. The trust would not be entitled to a charitable deduction because the trust does not create "separate shares."

The Service clearly stated its position on this issue in Chief Counsel Memorandum ILM 200848020. An IRA owner had left the account to a trust for his children and charities. Upon receiving distributions from the IRA, the trustee immediately funded the charities' shares, so that the children were the only beneficiaries left. The Memorandum concluded that the IRA distribution created taxable income with no offsetting charitable income tax deduction. The trust document contained no instructions to distribute the IRA to charity.

Obviously, we wanted to have the IRA included in the charity's income, not the trust's.

What we did. The trustee assigned the IRA to the charitable beneficiary. The assignment provided that the custodian distribute the IRA directly to the charity, and not to the trust.

Why we did it. This technique has been blessed by the Service in Several Private Letter Rulings, including 200652028, 200633009 and 2006180923.

The facts in PLR 200234019 are very similar to those in our situation. The estate assets were left to charities and individuals. The charities' shares were greater than the value of the retirement accounts. **The will contained two vital two provisions. Without them, this technique will not work.**

1. The executor could distribute assets "in cash or in kind".
2. In making those distributions, the executor could allocate assets among the beneficiaries without regard to their basis.

Drafting Tip: Be sure that the trust document includes both of the required provisions. Consider inserting language similar to the following:

> "To the greatest extent practical, the Trustee shall allocate and assign the Trust's interest in all Retirement Accounts, and not the proceeds of those Accounts, to the Charities' Share, and not to the Shares distributable to non-charitable beneficiaries."

Get it Right the First Time. You might not get a Second Chance.

In PLR 201021038, Distributions from an IRA could have been accumulated in a trust and been subject to the beneficiaries' power of appointment. The permissible appointees included charities. Because the beneficiaries could name non-individuals to receive the retirement benefits, there was no Designated Beneficiary. The IRA had to be distributed within a five year period.

The Trustees attempted a repair by obtaining a judgment from a state court modifying the terms of the trust.

The Service refused to recognize the effect of the post-mortem judicial reformation on the grounds that it was not authorized in the Code. For an example of an authorized reformation, see §2055(e)(3) regarding split-interest charitable trusts.

The **moral of the Story** is that, in some cases, one has to get it right the first time. You can eliminate unwanted beneficiaries by disclaimer. You can make distributions prior to the Designation Date. You can't repair a defective trust document.

Conclusion:

Trusts are wonderfully flexible estate planning tools, allowing our clients to protect their beneficiaries from the ravages of inability, disability, creditors and predators. They can save estate taxes.

Retirement plans are also wonderful things.

Putting these two wonderful things together sometimes creates a chamber of horrors. Probably the best avoidance technique is to ask, "do we need a trust at all?" If you do need a trust, then do what I do.

Consult Natalie Choate. Her book should have a prominent place in your library.