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MAKING RETIREMENT BENEFITS PAYABLE TO TRUSTS

2019 Edition

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Table of Contents

6.1 Drafting; Accounting; Transfers; Trusteed IRAs 3
6.1.01 Trust as beneficiary: Drafting checklist. 3
6.1.02 Trust accounting for retirement benefits 5
6.1.03 Trust accounting: Drafting solutions 7
6.1.04 "Total return" or "unitrust" method. 9
6.1.05 Transferring a retirement plan out of a trust or estate 10
6.1.06 Can a participant transfer an IRA to a living trust? 14
6.1.07 Individual retirement trusts (trusteed IRAs) 15

6.2 The Minimum Distribution Trust Rules 17
6.2.01 Advance rulings on see-through trust status 17
6.2.02 Who enforces the minimum distribution trust rules 18
6.2.03 Dates for testing trust's compliance with rules 19
6.2.04 What a "see-through trust" is; the "trust rules" 19
6.2.05 Rule 1: Trust must be valid under state law 20
6.2.06 Rule 2: Trust must be irrevocable 21
6.2.07 Rule 3: Beneficiaries must be identifiable. 22
6.2.08 Rule 4: Documentation requirement 24
6.2.09 Rule 5: All beneficiaries must be individuals 25
6.2.10 Payments to estate for expenses, taxes 25
6.2.11 Effect of § 645 election on see-through status. 27
6.2.12 Decanting, powers of appointment, and the RMD trust rules 27

6.3 RMD Trust Rules, cont.: Which Trust Beneficiaries Count? 28
6.3.01 If benefits are allocated to a particular share of the trust 29
6.3.02 Subtrusts cannot be "separate accounts," unless... 32
6.3.03 Beneficiaries "removed" by Beneficiary Finalization Date 34
6.3.04 Disregarding "mere potential successors" 36
6.3.05 Conduit trusts: Definition, requirements, effects. 36
6.3.06 Conduit trust: Administration issues 39
6.3.07 Accumulation trusts: Introduction 40
6.3.08 See-through accumulation trust ("STAT") 41

6.3.09 STAT: "Circle" trust 44
6.3.10 Accumulation trust: 100 percent grantor trust 44
6.3.11 Powers of appointment 45
6.3.12 Combining two types of qualifying trusts 46
6.3.13 IRS rulings that do not conform to these rules 47
6.3.14 Trust beneficiary's death: Effect on ADP 48

6.4 Estate Planning Choices 49
6.4.01 Do you care about see-through trust status? 49
6.4.02 Boilerplate provisions for trusts named as beneficiary 50
6.4.03 Should you use a separate trust for retirement benefits? 51
6.4.04 Planning choices: Trust for disabled beneficiary 51
6.4.05 Planning choices: Trusts for minors 54
6.4.06 Planning choices: Trust for spouse 58
6.4.07 Generation-skipping and "perpetual" trusts 60
6.4.08 "Younger heirs at law" as "wipeout" beneficiary 61

6.5 Trust Income Taxes: DNI Meets IRD 62
6.5.01 Income tax on retirement benefits paid to a trust 62
6.5.02 Trust passes out taxable income as part of "DNI" 63
6.5.03 Trust must authorize the distribution 65
6.5.04 Trusts and the IRD deduction 66
6.5.05 IRD and the separate share rule 67
6.5.06 IRD, separate shares, and discretionary funding 68
6.5.07 Income tax effect of transferring plan 69
6.5.08 Funding pecuniary bequest with right-to-receive IRD 70
6.5.09 The 3.8% additional tax on net investment income (NIIT) 71

Abbreviations Used in this Handout

§ Refers to a section of the Code unless otherwise indicated.
¶ Refers to a section of the author's book *Life and Death Planning for Retirement Benefits*
ADP Applicable Distribution Period.
BFD Beneficiary Finalization Date.
Code Internal Revenue Code of 1986 as amended through July 2018.
DNI Distributable net income.
IRA Individual Retirement Account.
IRD Income in respect of a decedent. See ¶ 4.6.01, Appendix A.
IRS Internal Revenue Service.
IRT Individual retirement trust (trusteed IRA). ¶ 6.1.07.
PLR IRS private letter ruling.
NIIT Net investment income tax. § 1411.
QRP Qualified Retirement Plan.
RBD Required Beginning Date.
RMD Required Minimum Distribution.
Reg. Treasury Regulation.
STAT See-through accumulation trust.

Minimum distribution, income tax, trust accounting, and estate planning considerations when retirement benefits are left in trust

6.1 Drafting; Accounting; Transfers; Trusteed IRAs

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

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

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

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

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

2. If the trust contains special provisions dealing with retirement benefits, define "retirement benefits" using a definition tailored to the objective of the special provision. For example, is the goal to include special payout provisions for retirement benefits that are eligible for the life expectancy payout method? See ¶ 6.4. Is the goal to leave all taxable retirement benefits to charity? See ¶ 7.4.06.

3. Draft the dispositive terms so they will operate on the retirement benefits in accordance with the donor's intent. For example: If the trust's dispositive terms will distinguish between "income" and "principal" consider how these terms will apply to the retirement plan and to distributions from it. See ¶ 6.1.02. If a beneficiary is given the annual right to withdraw "five percent of the trust principal," will the withdrawal power apply to the gross value of any retirement benefit that is payable to the trust (with or without a reduction for the built-in income tax "debt")? Or will it apply only to amounts the trustee has actually withdrawn from the retirement plan?

4. If the trust is intended to qualify for the federal estate tax marital deduction, comply with the requirements described in ¶ 6.1.02(D) below and in ¶ 3.3.02–¶ 3.3.09.

5. Determine whether see-through trust status is important (¶ 6.4.01). If it is important, The trust should be drafted so that it qualifies as a see-through trust (¶ 6.2–¶ 6.3) without the necessity of any trust amendments after the client's death. Post-death reformation to "fix" a noncomplying trust may not be possible; see ¶ 4.5.06.

6. If the trust is to be divided among multiple separate trusts for the benefit of different beneficiaries upon the client's death, see ¶ 6.3.01 regarding whether, if retirement benefits are allocated only to one particular trust, beneficiaries of the other trusts are disregarded for RMD 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. For the same reason, if leaving benefits to a trust for the participant's surviving spouse, and the trust is to pass outright to the participant's issue on the death of the surviving spouse, name the trust as beneficiary only if the participant's spouse survives the participant; name the issue directly as contingent beneficiaries if the spouse does not survive.

7. To avoid the issue of whether funding a pecuniary bequest with the "right to receive IRD" is a taxable transfer (¶ 6.5.08), avoid having retirement benefits pass through a pecuniary funding formula. If benefits must pass to a trust, make them payable to a trust that will not be divided up. If benefits are going to a trust that will be divided, either specify (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 RMD issues, even in a conduit trust. Since the Code itself imposes spendthrift restrictions on retirement plans (see § 401(a)(13)), such clauses are favored by government policy.

9. Consider whether certain classes of income should be directed to certain beneficiaries. For example, in a trust that authorizes the trustee to accumulate retirement plan distributions (¶ 6.3.07), the trust could direct the trustee to distribute the trust's "net investment income" to the life beneficiary, to avoid having the 3.8 percent additional tax on net investment income (the "NIIT"; ¶ 6.5.09) imposed on the trust; this could make sense if it is expected that the trust beneficiary will probably not have a high enough income to incur the NIIT. As to whether such an allocation of a specific class of income is respected for income tax purposes, see Regs. § 1.643(a)-5(b) and § 1.642(c)-3(b) (with respect to charitable beneficiaries) and Reg. § 1.652(b)-2(b) (other beneficiaries).

10. If the trust has charitable and noncharitable beneficiaries, either direct that the retirement benefits must be used to fund the charitable gifts (if the goal is to have the benefits pass

income tax-free to the charities) or forbid such use (if the goal is to achieve a stretch payout for the trust's individual beneficiaries).

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

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

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

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

B. Trust accounting income vs. RMD. See ¶ 6.2–¶ 6.3 regarding the "minimum distribution trust rules." RMDs and trust accounting income are totally different and unrelated concepts.

C. State law; the 10 percent rule of UPIA. 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 RMD, 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 Uniform Principal and Income Act ("UPIA"), as amended through 2008, which has been adopted by a majority of states, provides trust accounting rules for retirement plan distributions. UPIA Section 409 governs the trust accounting treatment of (among other things) any "payment" from an IRA or pension plan.

UPIA Section 409(b) provides, first, that, to the extent a payment from a retirement plan "is characterized as interest, a dividend, or a payment made in lieu of interest or a dividend, a trustee shall allocate the payment to income." The balance of any payment that is partly so characterized is

allocated to principal. The official Comment to Section 409(b) indicates that the drafters envisioned Section 409(b) as applying to a very narrow set of circumstances, namely, an employee benefit plan "whose terms characterize payments made under the plan as dividends, interest, or payments in lieu of dividends or interest." For example, under an employee stock ownership plan, the employee's plan account owns shares of company stock; when the stock pays a dividend, it is immediately distributed out of the plan to the employee (or, if he is deceased, to the beneficiary, in this case the trust). See § 404(k). The Comment continues: "[UPIA] Section 409(b) does not apply to an IRA or an arrangement with payment provisions similar to an IRA. IRAs and similar arrangements are subject to the provisions in [UPIA] Section 409(c)."

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

Unfortunately, the 10 percent rule will provide too little income in most cases, especially if the benefits are being paid out over a long life expectancy. For example, if the trust's Applicable Distribution Period (ADP; ¶ 1.2.03) is the 40-year life expectancy of the oldest trust beneficiary (¶ 6.2.07(A)), the first year's RMD 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 "income" portion of the distribution under UPIA Section 409(c) would be only 10 percent of that. It seems unlikely that a trust donor would choose this method of determining the amount of "income" to be distributed to the life beneficiary.

D. **Income for a marital deduction trust.** Trust accounting sometimes matters for tax purposes. Most importantly for estate planners, the definition of "income" matters for purposes of a trust transfers to which are intended to qualify for the federal estate tax marital deduction, because the spouse must be entitled to "all income" of such trust or the marital deduction will be disallowed. § 2056(b)(5), (7). Two other situations in which it matters under our Tax Code what is treated as income or principal for trust accounting purposes are:

- In the case of a qualified domestic trust (QDOT) for the benefit of a noncitizen spouse, distributions of "corpus" from a QDOT are subject to the deferred estate tax, while "income" distributions are not. See § 2056A(b)(3)(A), (B), and the author's *Special Report: Retirement Benefits and the Marital Deduction (Including Planning for the Noncitizen Spouse)*, downloadable at www.ataxplan.com; and

- In the determination of whether a trust is required to distribute all income currently so that it is taxed as a simple trust under § 651 rather than as a complex trust under § 661. Reg. § 1.651(a)-1.

Generally, the surviving spouse must be entitled for life to all income of a trust in order for such trust to qualify for the federal estate tax marital deduction. § 2056(b)(7)(B). This subsection "D" discusses what the "income" is that the spouse must be "entitled to" with respect to *retirement*

benefits left to a trust, in order for such trust to qualify for the federal estate tax marital deduction. See ¶ 3.3.02–¶ 3.3.07 for how to meet the "entitled" (and other) requirements to obtain the marital deduction for retirement benefits left to a trust.

A definition of "income" provided by applicable state law will be accepted for tax purposes if it "provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year…". Regs. § 1.643(b)-1, § 20.2056(b)-5(f)(1). The IRS has ruled that the UPIA 10 percent rule (see "C") of determining income "standing alone, 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…[RMD] 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, 2006-1 CB 939. The Revenue Ruling described two acceptable methods for determining the "income" of a retirement plan that the surviving spouse must be entitled to when such plan is payable to a marital deduction trust: either the plan's internal investment income ("trust-within-a-trust" concept ("Situation 1"); see ¶ 6.1.03(C)) or an acceptable (i.e., 3%–5%) annual "unitrust" percentage amount ("Situation 2"); see ¶ 6.1.04.

In response to Rev. Rul. 2006-26, the Uniform Law Commission amended UPIA Section 409. UPIA Section 409(d) now provides that the "characterized" rule and the 10 percent rule (UPIA Sections 409(b) and (c)) do not apply to a marital deduction trust. Instead, in the case of a marital deduction trust, the trustee shall treat each "separate fund" (*e.g.*, IRA or retirement plan) held by the trust as if it were itself a trust (trust-within-a-trust), determine the income of this separate trust under the rules of the UPIA, and (if requested to do so by the surviving spouse) demand that the person administering the IRA or plan distribute such internal income to the trust. If and only if the trustee cannot determine the internal income of the separate fund is the trustee to treat the separate fund as a "unitrust," in which case the fund's income will be based on a stated percentage of the fund's value. Additional rules are provided if the trustee is unable to determine the value. UPIA Sections 409(f), (g).

In their commentary, the Commissioners state that (Rev. Rul. 2006-26 notwithstanding) the focus of the UPIA's system is on the *payments received* by the trust, *not* on the underlying "separate fund" the trustee is withdrawing those payments from. The UPIA otherwise clings to the 10 percent rule, and the commentary makes clear that the amendments to Section 409 were designed solely "to satisfy the IRS' safe harbor," "Without necessarily agreeing with the IRS' position." Most states have adopted UPIA as amended through 2008. Trusts subject to the UPIA 2008 rule should not have a problem qualifying for the federal estate tax marital deduction.

6.1.03 ***Trust accounting: Drafting solutions***

Every trust drafter and trustee must check the applicable state law regarding its definition of "income" with respect to retirement benefits payable to the trust. Whether or not the trust is a marital trust, the UPIA's 10 percent rule normally will not produce reasonable results for the typical IRA held in a trust that makes different dispositions of income and principal. For example, a young beneficiary who is entitled only to the income of a trust may have the right to almost nothing under the 10 percent rule, if the trust's main asset is an IRA and the trustee takes only the RMD each year.

Though other provisions of the UPIA may permit or require the trustee to make adjustments if necessary to treat all beneficiaries fairly (see UPIA Sections 103(b), 104(a)), it might be preferable for the drafter to include a trust accounting provision that will produce, with respect to retirement benefits payable to the trust, results that carry out the client's intent. For example, the trust-within-a-trust approach (se "C") produces proper allocations of income and principal for the type of IRA most often seen in estate planning and trust situations, where the trustee controls the purchase and sale of investments "inside" the IRA, has complete access to all accounting information regarding those investments at all times, and has total control of when distributions are paid from the IRA to the trust's taxable account. The "trust within a trust" approach requires the trustee to account for the asset itself (i.e., the retirement plan benefit or the IRA), not (as most states' laws do) just for payments the trustee receives from the asset.

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

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

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

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

B. Draft your own definition of income. Another way to deal with the trust accounting problem is to provide, in the trust instrument, how retirement benefits are to be accounted for. The definition should be permitted under applicable state law and provide for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year if the trust must comply with the IRS's definition of income.

What should such a trust accounting provision say? 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. For example, the client may want the beneficiary to receive the entire RMD. The client may have no idea what he wants until you explain the alternatives.

C. **"Trust within a trust" approach.** One approach, which works for IRAs and other "transparent" defined contribution plans where the trustee controls the plan's investments, and can readily determine exactly how much income those investments earn and when, is to treat the retirement plan as a "trust-within-a-trust": Investment income earned inside the plan is treated as trust income just as if it had been earned in the trust's taxable account. The IRS has approved this approach for marital deduction trusts. ¶ 6.1.02(D).

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

The trust-within-a-trust approach will not work for a defined benefit plan (¶ 8.3.04), or any other plan where the trustee cannot readily get the information needed to compute the plan's internal income. Thus, there must be some type of default rule to cover these plans; see, *e.g.*, UPIA Section 409(g).

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

A trend in trust drafting is to eschew "income" and "principal" concepts in favor of a "total return" (also called "unitrust") approach: The life beneficiary receives a fixed percentage (unitrust percentage) of the value of the trust's assets each year, rather than receiving the traditional trust accounting income of rents, interest, and dividends. The UPIA (¶ 6.1.02(C)) authorizes the unitrust method when other methods cannot be used (see UPIA Section 409(g)).

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

Retirement benefits pose a valuation problem for the unitrust approach: Should the built-in income tax liability be deducted from the nominal value of the benefits? That issue can be avoided by distributing, each year, the required percentage of the retirement plan assets and the required percentage of the nonretirement assets. This method of implementing the unitrust approach was blessed, for a marital deduction trust, in Rev. Rul. 2006-26 (¶ 6.1.02(D)), "Situation 2."

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

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

A. **Transferability of IRA.** An IRA is transferable. The owner of an IRA (whether such owner is the participant or the beneficiary of the account) can transfer the ownership of the account to another person or entity. Nothing in § 408 (the statute that authorizes IRAs) prohibits transferring an IRA; on the contrary, the Code recognizes that IRAs can be assigned, since it discusses transfer of an IRA in connection with divorce (§ 408(d)(6)) and pledging the account as security for a loan (§ 408(e)(4)). The question is not whether the account can be transferred; the question is whether such transfer will be a taxable event. See, *e.g.*, CCA 2006-44020, in which the IRS ruled that a trust's transfer of an IRA in fulfilment of a pecuniary bequest conferred an immediate economic benefit on the trust and was accordingly taxable; the Chief Counsel Advice did not say the transfer itself was unlawful in any way.

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

A trust can make such a transfer to its beneficiaries regardless of whether the trust qualifies as a "see-through trust" under the minimum distribution rules (¶ 6.2). An estate can make such a transfer even though an estate can never qualify as a "Designated Beneficiary" (¶ 1.7.04).

The transfer of an inherited retirement plan or IRA from a trust or estate to the beneficiary(ies) of the trust or estate is solely for the purpose of allowing the trust or estate to terminate its own existence, or otherwise cease to have control of the benefits. Such a transfer generally has no effect on the Applicable Distribution Period for the benefits. The exception: Transferring the account out to individual beneficiary(ies) prior to the Beneficiary Finalization Date could change the ADP; see ¶ 6.3.03(A).

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

Foster Example: Division into marital and family trusts. Foster dies, leaving his IRA to the Foster Living Trust as beneficiary. The Foster Living Trust provides that, upon Foster's death, the trustee is to divide all assets into two separate trusts, the Marital Trust and the Family Trust, pursuant to a fractional formula. All retirement benefits are to be allocated to the Marital Trust. The trustee instructs the IRA provider to change the name of the owner of the inherited IRA from "Foster Living

Trust, as beneficiary of Foster, deceased," to "Marital Trust, as beneficiary of Foster, deceased." The trustee has transferred the IRA from the Foster Living Trust to the Marital Trust.

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

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

C. PLRs approving these transfers. Many private letter rulings have approved the transfer of inherited IRAs from the trust named as beneficiary of the IRA 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 an inherited IRA from a *trust* to the individual trust beneficiaries (without requiring termination of the IRA or otherwise triggering immediate income tax) are: PLRs 2000-13041, 2001-09051; 2003-29048 (IRA payable to a trust divided into four "sub-IRAs," each to be held by one of the individual trust beneficiaries); 2004-33019; 2004-44033–2004-

44034; 2004-49040–2004-49042; 2007-40018; 2007-50019; 2008-03002; 2010-38019; 2012-10045; and 2012-10047. Regarding transfer of an inherited IRA to *charitable* residuary beneficiaries, see 2005-26010, 2006-52028, and 2008-26028. See also the PLRs allowing a spousal rollover "through" a trust or estate (¶ 3.2.09).

In PLR 2010-13033, an IRA was payable to an estate; the IRS permitted transfer of the IRA from the estate to the "pourover" trust that was beneficiary of the estate, and thence to the trust's beneficiaries. For more PLRs, see ¶ 6.5.07(B).

Regarding transfer of *nonqualified annuities* to charitable residuary beneficiaries, see PLRs 2006-18023 (from an estate) and 2008-03002 (from a trust). For transfer of IRAs and 403(b) plans from an estate to charitable residuary beneficiaries, see PLR 2002-34019.

For rulings permitting Beneficiary IRAs to be opened directly in the name of the individual trust or estate beneficiaries (rather than first in the name of the trust or estate), where the IRA was payable to a trust or estate that was to terminate immediately upon the participant's death and be distributed outright to the individual beneficiaries, see PLRs 2005-38030, -38031, -38033, and -38034 (trust), and 2008-50058 and 2012-08039 (estate).

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

In PLR 2012-10047, "Decedent A" left his IRA to "Trust T." After payment of debts etc., Trust T was to terminate upon A's death and be distributed outright to his two sons, B and C. The IRS ruled that Trust T qualified as a see-through trust; and that "division of IRA X by means of trustee-to-trustee transfers into two inherited IRAs in the name of Decedent A (a) will not result in taxable distributions or payments under Code section 408(d)(1), and (b) will not constitute a transfer causing inclusion in the gross income of Trust T or either beneficiary under Code section 691(a)(2)." This was an unusually clear and thorough ruling; not all the rulings specifically mention § 691 (see ¶ 6.5.07).

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

the BFD and that is why she still counted as a beneficiary of the trust for purposes of determining the ADP.

D. Legal authority for such transfers. As the preceding sections show, there are many private letter rulings discussing and approving the transfer of an inherited retirement account out of the decedent's estate or trust to the beneficiaries of the estate or trust. Unfortunately, a PLR cannot be relied on or cited (by someone other than the person who obtained it) as a binding legal precedent. § 6110(k)(3).

The PLRs cited in this ¶ 6.1.05 cite (as their legal "authority") Rev. Rul. 78-406, 1978-2 CB 157, which established the rule that an IRA-to-IRA transfer is not a "distribution" and accordingly does not have to meet the requirements applicable to a "rollover." However, Rev. Rul. 78-406 did not deal with transferring an *inherited* IRA, let alone transferring it from a terminating trust (or estate) to the trust (or estate) beneficiaries. It dealt with a transfer from one IRA to another IRA in the same name (the participant's), which is not quite the same as a transfer from an IRA in the name of a trust as beneficiary to an IRA in the name of an individual or charity as successor beneficiary. Thus, to date, PLRs are still the only directly-on-point "authority" we have for IRS acquiescence in the transfer of a retirement plan out of a trust or estate.

However, even though a PLR does not rise to the level of binding precedent, it has some legal weight. For example, a PLR can serve as "substantial authority" for a position taken on a tax return for purposes of avoiding the penalty for substantial understatement of income (§ 6662(d)(2)(B)(i)), unless the PLR has been "revoked or...[is] inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement published in the Internal Revenue Bulletin." Reg. § 1.6662-4(d)(3)(iii).

Furthermore, the Supreme Court has held that the IRS can be bound by a position it has taken consistently in numerous PLRs. *Hanover Bank*, 369 U.S. 672 (1962). See, e.g., *Trimmer*, 148 T.C. 14 (2017) in which the Tax Court held that the taxpayer was entitled to receive from the IRS a hardship waiver of the 60-day rollover deadline (¶ 2.7.05), based on the IRS's previously issued PLRs granting such waivers to other taxpayers similarly situated: "...[A]lthough private letter rulings have no precedential effect...and taxpayers are not entitled to rely upon private letter rulings not specifically issued to them, private letter rulings may be instructive insofar as they 'reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws.'...We conclude that granting petitioners a waiver is consistent with the construction of section 402(c)(3)(B) that the Commissioner has employed in administering this provision over many years."

E. IRA providers and plan administrators. Some IRA providers readily permit these transfers, upon receipt of proper instructions from the fiduciary plus (in some cases) an opinion of counsel. However, some IRA providers do not allow these transfers.

A fiduciary faced with an IRA provider's refusal to allow transfer of an inherited IRA from a trust or estate to the trust or estate beneficiaries has four choices: #1. Cash out the IRA and give up further deferral. #2. Keep the trust or estate open until the end of the ADP, to preserve continued

deferral of distributions, but at the cost of ongoing administration expenses. #3. Get an IRS ruling, if that will convince the IRA provider to allow the transfer. #4. Move the account (still in the name of the estate or trust), by means of an IRA-to-IRA transfer (¶ 2.6.01(E)) 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.

F. Transferability of non-IRA plans. Theoretically non-IRA plans, such as QRPs, can be transferred out of a trust or estate to the trust or estate beneficiaries just as IRAs can be, but such transfers are much less common.

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

Nevertheless, these transfers are rarely permitted by qualified plans and rarely useful even if permitted. For example, if a 401(k) plan benefit is payable to the participant's estate, and the plan's only payout option is a lump sum distribution, there is no particular tax benefit to transferring (to the estate beneficiaries) the right to receive the lump sum distribution. The estate can instead just cash out the lump sum distribution and then pay it out to the beneficiaries and take an IRD deduction (¶ 6.5.02). The estate is not entitled to demand that the benefit be "direct rolled" to an IRA (because the estate is not a designated beneficiary; ¶ 4.2.04(C)). If the 401(k) benefit is payable to the deceased participant's trust, the trustee can demand that the benefit be direct-rolled to an inherited IRA if the trust qualifies as a see-through trust (¶ 6.2.04). If the trust does not so qualify, and the plan's only payout option is a lump sum, the trust is in the same position as the estate—there is no right to demand that the benefits be transferred to an inherited IRA and very little imaginable benefit to transferring to the trust beneficiaries the right to receive the lump sum distribution.

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

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

If the trust permits distributions to anyone other than the participant during the participant's life, the transfer might (despite Rev. Rul. 85-13) be considered a transfer of the benefits to another

person, which would terminate the account's status as an IRA. See § 72(e)(4)(A)(ii); Reg. § 1.408-4(a)(2); and *Coppola v. Beeson*, 419 F.3d 323 (5th Cir. 2005) (participant's pledge of his 403(b) account, as security for alimony he owed, treated as a distribution). Thus, the typical living trust provision that allows distributions to be made during the grantor's lifetime for the benefit of the grantor's dependents would not be suitable for a trust that is to hold the grantor's retirement benefits prior to his death. For a possible exception to this rule, see Reg. § 1.401(a)-13(e).

It would not be advisable to transfer an IRA to a grantor trust without first obtaining an IRS ruling. To date the only IRS pronouncements touching on the subject of transferring an IRA to a grantor trust are five private letter rulings. There are three favorable rulings dealing with a beneficiary's transfer of an *inherited* IRA (PLRs 2006-20025, 2008-26008, and 2011-16005, discussed at ¶ 4.6.03(C)).

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

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

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

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

Troy Example: Troy has a $1 million trusteed IRA with X Trust Co. X manages the investments and pays the annual RMD to Troy, along with such additional distributions as Troy may request from time to time. Upon Troy's death, X, as Trustee and IRA provider, continues to hold the account for the benefit of Troy's wife Joy. As provided in the IRA-trust document, X pays to Joy, annually, the greater of the RMD or the income earned by the IRA, and such additional amounts as X, as trustee, deems advisable for her health and support. After Joy's death, X pays annually to Troy's children,

in equal shares, the RMD. As each child reaches age 40, he gains the right to withdraw additional amounts from his share of the trusteed IRA.

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

- **Participant's disability**. The IRT agreement can authorize the trustee to use the IRT assets for the participant's benefit during disability. An IRA custodian will not perform those duties; custodial IRA assets can be used for the benefit of the disabled participant only through the mechanism of a durable power of attorney or guardianship.

- **Limit beneficiary's access**. An IRA beneficiary can generally withdraw the entire account at will. An IRT can limit the beneficiary's withdrawal rights so that the beneficiary can withdraw only the RMDs; or RMDs plus such additional payments (such as for health or support) as the trust document (agreed to by the participant and trustee) permits. Thus, it may be used in place of a conduit trust in some cases. See ¶ 6.3.05, ¶ 6.4.05(A).

- **Limit beneficiary's control at beneficiary's death**. Under an IRT, but not under most custodial IRAs, the *participant* can specify the "successor beneficiary, " i.e., the person or entity who will become the owner of the account after the original beneficiary's death. See ¶ 1.5.12(E) .

- **Avoid complications of RMD trust rules.** A trust named as beneficiary of a custodial IRA must meet complicated IRS requirements to qualify as a "see-through trust" (¶ 6.2–¶ 6.3). An IRT does not have to jump through these hoops, because the trust is not the beneficiary of an IRA—it *is* the IRA.

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

Any bank can serve as trustee of a trusteed IRA; no special IRS approval is required. The bank needs to be familiar with the requirements applicable to IRA providers. Then, all that is required is for the participant and IRA provider to enter into a trust agreement that complies with § 408. The parties can use IRS Form 5305, "Traditional Individual Retirement Trust Account" (or 5305-R for a trusteed Roth IRA), adding any extra provisions appropriate for the client's estate plan as an attachment (see "Article VIII" of Form 5305). The estate planning lawyer should have a

leading role in preparing this document. IRS approval is not required and in fact cannot be obtained for an individual's IRA or IRT.

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

6.2 The Minimum Distribution Trust Rules

As explained in Chapter 1, after a retirement plan or IRA owner (the "participant") dies, the retirement plan or IRA must make certain annual Required Minimum Distributions (RMDs) to the beneficiary(ies) of the account. See ¶ 1.5.

The most desirable form of post-death payout, generally, is annual instalments over the life expectancy of the beneficiary. This method generally allows the longest tax deferral (or tax-free accumulation, in the case of a Roth plan). See ¶ 1.1.03, ¶ 1.5.05. This sought-after "stretch" or "life expectancy" payout is available only for benefits payable to a "Designated Beneficiary." ¶ 1.7. Generally a Designated Beneficiary must be an individual. See ¶ 1.7.03. However, IRS regulations allow a trust named as beneficiary of the plan or IRA to qualify for this favorable form of payout if certain requirements are met. These requirements (the "IRS's minimum distribution trust rules" or the "see-through trust rules") are explained in this ¶ 6.2 and in ¶ 6.3. For the estate planning and drafting implications of these rules, see ¶ 6.4.

This ¶ 6.2 contains the rules. ¶ 6.3 elaborates on one vexing aspect of the minimum distribution trust rules, namely, which trust beneficiaries "count" for purposes of the requirements that "all trust beneficiaries must be individuals" (Rule 5) and the oldest trust beneficiary's life expectancy is the Applicable Distribution Period for benefits payable to the trust (¶ 6.2.07(A)).

*6.2.01 **Advance rulings on see-through trust status***

In view of the uncertainties surrounding the RMD trust rules (see, *e.g.*, ¶ 6.3.07), should the estate planner consider seeking (while the client is still living) an IRS ruling on the question of whether a trust qualifies as a see-through? Obviously this route would be expensive and time-consuming. In PLR 2003-24018, the IRS stated that "Trust M," the taxpayer's revocable trust which she proposed to name as beneficiary of her IRA, "complies with the requirements of the Final Regulations so that, as a result, the beneficiaries of Trust M may be looked at to determine which, if any, is the designated beneficiary of Taxpayer's rollover IRA." However, the IRS stated it was nevertheless "unable" to rule on the Applicable Distribution Period that would apply after the taxpayer's death until after the taxpayer had died. To date, the IRS has not issued any other PLR to any still-living participant affirming the see-through trust qualification of a trust named as such participant's beneficiary.

The IRS does not in other contexts 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. See also PLRs 9321059, 9348025, and 9418026 in which the IRS ruled that trusts that living taxpayers *proposed* to name as beneficiaries of their respective IRAs would qualify for the marital deduction.

6.2.02 ***Who enforces the minimum distribution trust rules***

The person primarily responsible for verifying that the trust qualifies as a see-through trust is the **trustee of the trust** named as beneficiary. The trustee is the one who must comply with the minimum distribution rules by correctly calculating (and taking) the annual required distribution. If the trustee fails to take a required distribution the trust will have to pay the resulting 50% excise tax. § 4974(a); ¶ 1.9. It is highly recommended that the trustee of a trust named as beneficiary of a retirement plan obtain a legal opinion regarding the trust's qualification as a see-through trust (or not). This will show (in case of any challenge by the IRS) good faith effort to comply with the tax rules, or (if the opinion is that the trust does not qualify as a see-through trust) shield against a possible beneficiary claim that the trustee should have used the life-expectancy payout method.

The **plan administrator** of a qualified retirement plan (QRP) also cares about compliance with the minimum distribution rules, because failure to comply could lead to plan disqualification. § 401(a)(9). When a trust is named as beneficiary of a QRP, the plan administrator might request a legal opinion regarding the trust's compliance with the minimum distribution trust rules before (for example) permitting a direct rollover to an inherited IRA (¶ 4.2.04).

An IRA does not have to be "qualified" in the same way a qualified plan does. Accordingly, an **IRA provider** theoretically does not have as much of a stake as a QRP administrator would in the question of whether a trust named as beneficiary of the account does or does not qualify as a see-through trust. However, IRA providers cannot ignore the tax rules applicable to their IRAs. For one thing, they need to correctly report (to the IRS) any distributions and "deemed" distributions from the IRA. Most IRA providers will seek some assurance that a trust qualifies as a see-through trust, either by reviewing the trust terms in-house (some IRA providers have legal staff for this) or by requesting a legal opinion or even an IRS ruling. While an in-house review or request for a legal opinion seem reasonable, an IRS ruling (expensive and time-consuming to obtain) should generally not be required.

Least acceptable, occasionally an IRA provider will demand a "hold harmless agreement" from the trustee or trust beneficiaries before acceding to their requests for a direct rollover, life expectancy payout, or transfer out of the trust (¶ 6.1.05). Such a demand seems to be an admission that the IRA provider believes it is not complying with the tax laws but wants someone else to pay for its transgression. How a few bereaved individuals can be expected to "hold harmless" a huge financial institution from its transgressions is a mystery. If the IRS comes after the IRA provider for some violation of the tax law, it will be no defense to argue "But we got a hold harmless agreement!" That is not a recognized defense to any tax penalty or other tax violation.

*6.2.03 **Dates for testing trust's compliance with rules***

The trust requirements must be met "during any period during which required minimum distributions are being determined by treating the beneficiaries of the trust as designated beneficiaries of the employee." Reg. §1.401(a)(9)-4, A-5(b). More specifically:

The regulations give no specific testing date for the requirement that the trust must be valid under state law. The examples in the regulation refer to a trust that is valid under state law as of the date of death. Reg. §1.401(a)(9)-5, A-7(c)(3), Examples 1 and 2. The irrevocability requirement must be met as of the date of death. ¶ 6.2.06.

For the documentation requirement deadline, see ¶ 6.2.08.

If the requirement that the beneficiaries be identifiable is not met as of the date of death, it may be possible to cure the problem by actions prior to the Beneficiary Finalization Date. See ¶ 6.3.03.

The requirement that all beneficiaries must be individuals must be met as of the Beneficiary Finalization Date. Reg. §1.401(a)(9)-4, A-5(c), A-4(a). See ¶ 6.2.09, ¶ 6.2.10, ¶ 6.3.03.

*6.2.04 **What a "see-through trust" is; the "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. § 401(a)(9)(B)(iii); ¶ 1.5.01. 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: If the trust passes several rules, it is considered a look-through or see-through trust, and the individual trust beneficiaries are treated as if they had been named directly as beneficiaries of the plan or IRA—for *some*, but not *all*, of the minimum distribution rules.

Before turning to the five official "trust rules," be aware of two preliminary rules.

A. **Rules apply to the retirement benefits and "proceeds."** For purposes of testing a trust for compliance with the trust rules, a trust's interest in a retirement plan includes not just the retirement plan itself and the distributions from the retirement plan, but also the proceeds resulting from the trust's reinvestment of the retirement plan distributions. Reg. § 1.401(a)(9)-5, A-7(c)(1), third sentence.

B. **If benefits pass from one trust to another.** If a "countable" beneficiary (¶ 6.3) of the trust is another trust, then both trusts must "pass" the trust rules. Reg. § 1.401(a)(9)-4, A-5(d). See ¶ 6.2.12 regarding the effect of **decanting** with respect to this rule. Note that 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(C). Thus, the remainder beneficiary of a conduit trust can be a trust that does *not* comply with the trust rules.

C. **The five "RMD trust rules."** Reg. § 1.401(a)(9)-4, A-5(b), contains the IRS's four "minimum distribution trust rules" (also called the RMD trust rules):

1. The trust must be valid under state law. ¶ 6.2.05.

2. "The trust is irrevocable or will, by its terms, become irrevocable upon the death of the" participant. ¶ 6.2.06.

3. "The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit" must be "identifiable...from the trust instrument." ¶ 6.2.07.

4. Certain documentation must be provided to "the plan administrator." ¶ 6.2.08.

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

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

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

D. Effective date of RMD trust rules

The regulations explained here apply for purposes of determining RMDs payable to trusts for 2003 and later years. Reg. § 1.401(a)(9)-1, A-2(a). For different versions of these rules applicable for earlier years, see the *Special Report: Ancient History* (www.ataxplan.com).

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

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

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

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

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

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.

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

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

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

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

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

Also, the spouse's power of revocation is not a problem to the extent the IRA exceeds the spouse's 50 percent interest; if her power is to revoke only 50 percent of the trust, and the IRA represents more than 50 percent, the excess is not subject to the power, and so the rule is not violated as to that excess portion. See PLR 1999-18065 [this PLR's holdings were otherwise superceded by the final RMD regulations in 2002].

Thus Rule 2 matters for Steve's trust, if at all, only to the extent that Imelda could, *but chooses not to*, satisfy her community property interest by withdrawing the IRA. If Imelda takes her

$800,000 by withdrawing $200,000 from the IRA plus $600,000 from the other assets, that leaves $800,000 of the IRA still in the trust. Since Imelda *could* have revoked the trust as to an additional $600,000 of the IRA that is still in the trust, the IRS might say the trust flunks Rule 2 as to $600,000 worth of the IRA. There are no rulings on point.

6.2.07 ***Rule 3: Beneficiaries must be identifiable***

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

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

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

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

Actually, there *is* theoretically a problem even with this common provision. If people who are issue by virtue of adoption are to be included, there is a potential for violating the rule. After the participant's death, one of his issue could adopt someone who was born earlier than the person who was the oldest beneficiary when the participant died. It is not known whether the IRS would ever raise this "issue"; they seem to ignore this possibility in (*e.g.*) PLR 2012-03033. To avoid the problem the trust could provide that older individuals cannot later be added to the class of beneficiaries by adoption.

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

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

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

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

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

C. Anyone in the world younger than a certain individual. Sometimes the IRS expresses the "identifiable" requirement thus: "…the identity of the beneficiaries…can be determined by perusing…[the trust's] terms." PLRs 2005-21033, 2005-22012, 2005-28031, 2006-07031, 2006-10026, 2006-20026, and 2007-08084 use that exact phrase, and PLRs 2002-09057 and 2004-38044 use similar wording. What this phrase means, if anything, has yet to be established. If the IRS is suggesting that the "identifiable" test requires only that the identity of the beneficiaries can be determined from the trust instrument then the rule is redundant: A trust under which the identities of the beneficiaries could not be determined by "perusing" the trust instrument would presumably not be valid under state law and therefore would violate Rule #1 (¶ 6.2.05).

If the benefits are payable to a trust under which the trustee has absolute discretion to pay the benefits to "my son John and/or any individual in the world who is younger than John," are the beneficiaries identifiable? Not in the normal sense of the word; though we know who the oldest

potential beneficiary is (John), we cannot determine the identity of the beneficiaries by "perusing" the trust. We cannot know who is entitled to the benefits until the trustee makes his selection.

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

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

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

A. Post-death distributions. The deadline for supplying the required documentation with respect to post-death distributions is October 31 of the year after the year of the participant's death. Reg. § 1.401(a)(9)-4, A-6(b). 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 RMDs if the participant is using the Uniform Lifetime Table (¶ 1.2.03). Therefore, the participant has no need to comply with the documentation requirement or other trust rules

for his lifetime distributions *unless*: (1) the participant has named a trust as his sole beneficiary; (2) the participant's more-than-10-years-younger spouse is the sole beneficiary of the trust (see ¶ 1.6.06); and (3) the participant wants to use the spouses' joint life expectancy (rather than the Uniform Lifetime Table) to measure his RMDs. 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 RMDs. The conservative assumption would be that the deadline is the beginning of the distribution year in which the spouses' joint life expectancy is to be used as the ADP. The person who must fulfill this requirement is the participant (not the trustee, as is the case when the participant dies).

C. **If incorrect trust documentation is supplied.** If the participant (in the case of lifetime RMDs) or the trustee (in the case of post-death RMDs) completes the certifications incorrectly, or sends a copy of the wrong trust instrument to the plan administrator, the regulations let the *plan* off the hook: The plan will not be disqualified "merely" because of these errors, provided "the plan administrator reasonably relied on the information provided and the required minimum distributions for calendar years after the calendar year in which the discrepancy is discovered are determined based on the actual terms of the trust instrument." Reg. § 1.401(a)(9)-4, A-6(c)(1). This wording suggests that the trust can still qualify as a see-through, even though incorrect information was provided to the administrator initially. The 50 percent excise tax (which is payable by the person required to take the RMD; see ¶ 1.9.02) will be still be based on what should have been distributed "based on the actual terms of the trust in effect." Reg. § 1.401(a)(9)-4, A-6(c)(2).

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

The result of compliance with the first four rules is that the trust beneficiaries will be treated, for *most* purposes of the minimum distribution rules, as if the participant had named them directly as beneficiaries (for exceptions see ¶ 6.3.02(A) and ¶ 1.6.06). 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 the participant's estate is not an individual and therefore cannot be a Designated Beneficiary. ¶ 1.7.04. 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. Regarding benefits that may pass to the participant's estate, see ¶ 6.2.10; regarding a beneficiary's estate, see ¶ 6.3.13. Once that hurdle is cleared we consider which trust beneficiaries, if any, can be disregarded in applying this rule. See ¶ 6.3.

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

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

However, despite suggestions in some PLRs (see, *e.g.*, PLR 9809059) that such a provision might disqualify a trust, there is no evidence that the IRS really does (or ever did) take this position. There is no published instance of any trust's ever having lost see-through status on account of such a clause. If this type of clause is a problem, the risks of disqualification can easily be avoided either at the planning stage (see first bullet point below) or post-mortem (see other bullet points).

Many PLRs blessing see-through trusts do not even mention the subject; see PLRs 2002-08031, 2002-11047, 2002-18039, 2003-17041, 2003-17043, and 2003-17044. Every letter ruling that mentions such a clause in a trust finds some reason why the trust nevertheless qualifies as a see-through. The IRS has recognized trusts as see-throughs, despite a trust clause calling for payments to the estate for debts, expenses, and/or taxes, where:

- The trust forbade the distribution of *retirement benefits* to the participant's estate (PLRs 2002-35038–2002-35041) or to any nonindividual beneficiary (PLRs 2004-10019–2004-10020), either altogether or (as in PLRs 2004-53023, 2006-08032, and 2006-20026) after September 30 of the year after the year of the participant's death (see ¶ 1.8.03).

- The trustees asserted either that applicable state law prohibited use of the retirement benefits for this purpose (either directly or through application of some fiduciary standard), or that state law exempted such benefits from creditors' claims. See PLRs 2001-31033, 2002-23065, 2002-28025, 2002-44023, 2004-33019, 2004-40031, 2005-38030, and 2006-20028.

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

- The trustees represented that all such liabilities had been satisfied from assets other than the IRA; this was stated in the recital of facts, but not reiterated in the actual "ruling," which suggests that this fact was not essential to the ruling. PLR 2015-03024.

In PLR 2004-40031, the IRS ruled favorably where the trust (despite a state law exempting retirement benefits from creditors' claims) was forced by a state court to use IRA proceeds to pay creditors because there were no other assets available.

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

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

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

6.2.12 ***Decanting, powers of appointment, and the RMD trust rules***

Reg. § 1.401(a)(9)-4, A-5(d) (¶ 6.2.04(B)) dictates that, if retirement benefits (or proceeds thereof) are to pass from one trust to another, *both* trusts must pass the minimum distribution trust rules. If retirement benefits are to pass from one trust that was named as beneficiary of the retirement plan (the "original" trust) to another trust (the "transferee" trust), therefore, it is necessary that both trusts pass the RMD trust rules—unless the transferee trust can be ignored as a "mere potential successor" under the rules explained at ¶ 6.3.04.

If benefits are to pass from the original trust to another trust, and the transferee trust cannot be so "ignored," then it would appear that the transferee trust must be one that was created at the participant's death, not at some much later date. Otherwise there is no way the transferee trust can "pass" the rules that the trust must be irrevocable as of the date of the participant's death (¶ 6.2.06) and a copy must be given to the plan administrator no later than October 31 of the year after the year of the participant's death (¶ 6.2.08).

There are three paths by which assets held in the original trust may be transferred to another trust:

- **Trustee's power or obligation to transfer.** The original trust may authorize or require the trustee to transfer assets from the original trust to another trust (fiduciary power). Unless this power applies only to interests that are "ignorable" under the "mere potential successor" rule (¶ 6.3.04), the power should be limited to transferring only to trusts that comply with the

RMD trust rules, the beneficiaries of which are younger than the intended-to-be oldest beneficiary of the original trust.

- **Beneficiary's power of appointment.** The original trust may grant a beneficiary a power of appointment (for example, a testamentary power of appointment over a trust fund held for such beneficiary's life), and the power of appointment may include (either under the specific terms of the original trust or under applicable state law) the power to appoint in further trust. The IRS has never commented on the effect of such a state law or of an explicit power in an instrument to appoint to another trust. Unless the power of appointment applies only to interests that are "ignorable" under the "mere potential successor" rule (¶ 6.3.04), the power should be limited to appointing only to individuals who are younger than the intended-to-be oldest beneficiary of the trust or to trusts that comply with the RMD trust rules and who have no beneficiaries older than the intended-to-be oldest beneficiary of the original trust.

- **Decanting.** Even when the original trust contains no specific grant of a fiduciary power to pay to another trust, and no power of any beneficiary to appoint to another trust, applicable state law may permit "decanting" of assets from the original trust to another trust. Decanting can involve transferring the entire corpus of the original trust to a different trust or paying all or part of the share of a trust beneficiary to another trust for that beneficiary. Decanting may be done for a variety of tax and nontax reasons. Decanting has become a more common practice than it was when the "RMD trust rules" were issued in 2002.

Typically though not necessarily the transferee trust is newly-created for the purpose of receiving the decanted assets. Thus, decanting (as normally practiced) is not limited to trusts that comply with the RMD trust rules. Unless the decanting occurs very shortly after the participant's death, it typically would not be possible to decant to a trust a copy of which was given to the plan administrator no later than October 31 of the year after the year of the participant's death (¶ 6.2.08).

For decanting to be problematic for see-through trust status it is not necessary that decanting actually occur. The mere possibility that under applicable state law the trust-held retirement benefits (or proceeds thereof; ¶ 6.2.04(A)) could be decanted into a noncomplying trust would appear to make see-through trust status impossible. Trust-drafters may wish to include in their trust instruments a provision prohibiting decanting of retirement benefits or proceeds thereof to any trust that does not qualify as a see-through trust. No case or IRS pronouncement has addressed this conundrum.

6.3 RMD Trust Rules, cont. Which Trust Beneficiaries Count?

There is no special difficulty in determining whether the trust is valid under state law (Rule 1; ¶ 6.2.05), and irrevocable at the participant's death (Rule 2; ¶ 6.2.06), or that proper documentation has been supplied to the plan administrator (Rule 4; ¶ 6.2.08(A)). The hard part of testing a trust under the RMD 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 in determining

which trust beneficiaries "count" for purposes of these two rules, and which beneficiaries may be disregarded. This involves a three-step process:

Step 1: Disregard any beneficiary who predeceased the participant. For example, if the trust says "Pay income to my spouse, and upon my spouse's death distribute the trust to my issue," and the participant's spouse predeceased him, the spouse is not a countable beneficiary.

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

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

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

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

What is a subtrust?

The word "subtrust" does not appear in the typical dictionary, and in a law dictionary it may come with an ancient definition now disused. As used by the IRS in PLRs, and as used in this book, a subtrust is a separate trust created by transfer from another trust, or under a single trust instrument that creates multiple trusts. For example, if X leaves his estate and his IRA to the "X Living Trust," and upon X's death the trustee of the X Living Trust is directed to divide the trust assets into a "marital trust" and a "credit shelter trust," or into separate trusts for each branch of X's descendants, the marital trust, credit shelter trust, and separate trust for each branch are all "subtrusts." Legally and for purposes of the income tax code a subtrust is just a trust; it is not in any way different from the "original," "master," or "funding" trust out of which it was formed. The subtrust is a separate "legal entity" (as much as any trust is) with its own taxpayer i.d. number and filing its own tax returns. The word "subtrust" is used solely to distinguish the separate trusts created out of the original trust instrument from the "original" trust whose trustee acted to carry out the terms of the original trust by creating more trusts.

The question discussed here is whether the "identifiable" and "all-beneficiaries-must-be-individuals" tests (RMD trust rules 3 and 5; ¶ 6.2.04) are applied to the entire trust (i.e., all possible beneficiaries of all shares and subtrusts created by the trust instrument), or rather are applied only to the beneficiary, share, or subtrust that ends up with the retirement benefits. Can we disregard beneficiaries of shares/subtrusts that do not receive any portion of the retirement benefits? As the following discussion shows, the answer to this question is surprisingly unclear. In analyzing any particular trust, it should not be assumed that, merely because the benefits are allocated to one particular beneficiary, share, or subtrust, other trust beneficiaries, or beneficiaries of other shares or subtrusts, will be disregarded in applying the RMD trust rules.

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

Thus, the regulations seem to state that, even if the benefits are payable to a funding trust (such as the participant's revocable living trust), we are not required to test all potential beneficiaries of the *funding trust,* if the benefits are allocated only to certain beneficiaries or to particular subtrusts created under the funding trust. Instead, this wording suggests, we look only at the beneficiaries of the subtrust(s) that actually receive(s) (or possibly only at beneficiaries that *could* receive) the retirement benefits, because they are the only beneficiaries "with respect to the trust's interest in the benefits." Unfortunately the IRS pronouncements (all of which are in private letter rulings) are not consistently supportive of this view; see (C)–(E) below. The IRS has been known to confuse this question with the entirely different issue of "separate accounts" treatment (¶ 6.3.02); see, *e.g.*, PLR 1999-03050.

B. Subtrust named directly as beneficiary of the benefits. One thing is clear: If the participant's beneficiary designation form names one or more particular subtrusts directly as beneficiary of the plan, rather than naming the funding trust, then the only beneficiaries who "count" for purposes of the trust rules are the beneficiaries of the subtrust(s) named as beneficiary. See PLRs 2005-37044, 2006-07031; no PLR contradicts this conclusion.

C. Instrument mandates allocation. Assume retirement benefits are payable to a "funding" trust. The trust instrument either: requires that the benefits be allocated to a certain subtrust or to certain beneficiaries; mandates that the benefits *cannot* be paid to certain beneficiaries or shares, regardless of the amount of the benefits or any other factors; or contains a formula, application of which necessarily results in the benefits' being allocated to a particular share or beneficiary. It would appear that the beneficiaries of the shares to which (as a result of such provisions) the benefits cannot be allocated should be disregarded; however, rulings on this point are sparse.

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

Libby Example: Libby's IRA is payable to the Libby Trust. On Libby's death, the trustee is to divide the trust into equal halves, Subtrust A and Subtrust B. Subtrust B is to be funded to the maximum extent possible with retirement benefits. Assume the IRA is fully used in funding Subtrust B as a result of this formula provision. Can the beneficiaries of Subtrust A be disregarded in applying the RMD trust rules? Yes, according to PLR 2006-20026, involving an IRA and QRP payable to "Trust T." Trust T was to be divided into Subtrusts A and B upon the participant's death by means of a formula. As a result of applying the formula, the benefits "had to be allocated to Subtrust B." The ruling then proceeded to analyze only Subtrust B, with no mention of the terms or beneficiaries of Subtrust A. An earlier contrary ruling (PLR 1999-03050) was decided under the proposed regulations and thus can be regarded as superceded.

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

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

D. **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 RMD trust rules? The IRS has ruled both ways on this question. In PLRs 2005-28031–2005-28035 (dealing with the same trust), the IRS said "no": Because the allocation to a particular trust share "was made in accordance with…[state law] and not in accordance with the beneficiary designation," beneficiaries of other shares of the trust could not be ignored in applying the RMD trust rules. In contrast, in PLR 2007-08084 the IRS ruled that beneficiaries whose shares could not (under applicable state law) be funded with the retirement benefits were disregarded.

E. 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 RMD trust rules?

Though this seems like the worst case for convincing the IRS that other beneficiaries of the trust should be ignored, the IRS granted a favorable ruling in just that situation. In PLRs 2002-21056, 2002-21059, and 2002-21061 (all dealing with the same trust) all pre-residuary beneficiaries of a trust (including charities) were ignored in determining the Applicable Distribution Period for retirement benefits payable to the trust because the trustees (although they could have used the benefits to fund the pre-residuary bequests) were legally and financially able to, and did, satisfy the pre-residuary bequests out of other assets of the trust, and the pre-residuary beneficiaries did not have the right under state law to demand that they be paid out of the retirement benefits. These PLRs were issued under the 2001 proposed regulations (¶ 1.1.01) so may be of little predictive value.

6.3.02 ***Subtrusts cannot be "separate accounts," unless...***

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

When a participant leaves his IRA in fractional or percentage shares to multiple beneficiaries, the inherited account may be divided into separate "inherited IRAs," one payable to each of the multiple beneficiaries. Once this division occurs, the separated accounts are treated as separate inherited IRAs for most purposes of the minimum distribution rules (generally, beginning the year after the division). ¶ 1.8.01. However, there is a significant exception to the separate accounts rule for retirement benefits payable to a trust:

A. No separate accounts for ADP purposes. Separate inherited IRAs established after the participant's death are NOT treated as separate accounts *for purposes of determining the Applicable Distribution Period* (even if the division into separate accounts occurs on or before December 31 of the year after the year of the participant's death), if the division into separate accounts occurs by operation of a single trust that is named as beneficiary. See Reg. § 1.401(a)(9)-4, A-5(c), as applied in PLRs 2003-17041, 2003-17043, 2003-17044, 2004-32027–2004-32029, 2004-44033–2004-44034, and 2015-03024.

Accordingly, if a participant wants a life expectancy payout to be available for each of multiple beneficiaries based on each such beneficiary's *own* life expectancy (or for each of multiple separate trusts based on the life expectancy of the oldest beneficiary of *each* such trust), the participant should name the individuals (or trusts) directly as beneficiaries *in the beneficiary designation form*, rather than naming a single funding trust as beneficiary of the retirement plan. See PLRs 2005-37044, 2006-07031.

Prior to issuance of the final minimum distribution regulations in 2002, separate accounts treatment *was* available for multiple beneficiaries taking under a single trust. In PLR 2002-34074 (issued in May 2002, after the final regulations were issued, though this PLR was decided under the

proposed regulations), 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 RMD 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 single trust.

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

Accordingly, the individuals who obtained PLR 2002-34074 wasted their money. The ADP for their benefits must be redetermined (for years after 2002) under the final regulations, and under the final regulations the ADP for their benefits will be based on the oldest trust beneficiary's life expectancy (as in, for example, PLRs 2002-35038–2002-35041).

B. **Separate accounts for purposes other than ADP.** Although Reg. § 1.401(a)(9)-4, A-5(c), states that separate accounts cannot be established *for any purpose of the minimum distribution rules* for benefits that are left to multiple beneficiaries through a single funding trust, PLRs make clear that in fact the IRS means such separate accounts can be established for all RMD purposes other than determining the ADP. Thus, for example, if an IRA is payable to a trust that is to terminate immediately upon the participant's death and be distributed outright to the decedent's three children, the trust can divide the IRA into separate inherited IRAs and transfer one such separate inherited IRA to each of the children (see ¶ 6.1.05). Thereafter, the children's respective separate inherited IRAs (or "sub-IRAs" as the IRS calls them in some PLRs) will be treated as "separate accounts" for all minimum distribution purposes *except* determination of the ADP (which will be determined, for all the accounts, based on the life expectancy of the oldest beneficiary). See PLRs 2000-13041, 2001-31033, and 2002-35038–2002-35041.

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

This result is not strictly in accordance with the regulations. If separate accounts "exist" but are not recognized for RMD purposes, then the regulation provides that: "the separate accounts will be aggregated for purposes of satisfying the rules in section 401(a)(9). Thus,...all separate accounts...will be aggregated for purposes of section 401(a)(9)." Reg. § 1.401(a)(9)-8, A-2(a)(1). What the regulation "really means" (apparently) is that separate accounts treatment IS available for benefits that are payable to different beneficiaries through an estate, or through a single trust named as beneficiary, *for all purposes other than determining the ADP*.

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

Step 1: He must cause a separate trust to be established for each such beneficiary. These separate trusts can be established (i.e. set up and funded) after his death, and can all be established under a single trust instrument, as long as each such trust is (at the time it receives the inherited benefits) a separate trust under applicable state law, with its own taxpayer identification number (TIN) and filing its own annual tax return. It is not possible to have separate account treatment for any RMD purpose for shares of an IRA that are payable to a single trust that has multiple beneficiaries, even if the multiple beneficiaries have "separate shares" under the single trust for other income tax purposes (¶ 6.5.05).

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

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

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

A beneficiary does not "remain" such if such beneficiary's interest in the benefits has been eliminated by either distribution (see "A"), disclaimer (see "B"), or other means (see "C"). The *death* of a trust beneficiary prior to the Beneficiary Finalization Date may or may not eliminate him as a beneficiary. If the deceased beneficiary's estate has no further right to or claim against the trust or retirement benefits as of the BFD, it would appear that the decedent should not be a "countable" beneficiary. But see PLR 2004–38044 which states in passing that the participant's surviving spouse (who was life beneficiary of the trust named as beneficiary of a qualified plan, and who did not die before the BFD) would still have been a "countable beneficiary" even if she had died before the BFD, because she survived the decedent. See ¶ 1.8.03(C).

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

A. Distribution on or before September 30. Suppose retirement benefits are payable to a trust that has multiple beneficiaries. For purposes of qualifying for a payout of these benefits based on the life expectancy of a young individual beneficiary of the trust, the trustee may wish to "eliminate" one or more nonindividual beneficiaries of the trust (to satisfy the "all beneficiaries must be individuals" rule; ¶ 6.2.09) or one or more older beneficiaries (so the

trust's ADP will be based on the life expectancy of a younger "oldest trust beneficiary"; ¶ 6.2.07(A)). There are three ways that distribution can be used to "eliminate" an older or nonindividual beneficiary. Each option is available only if permitted by the trust instrument.

One is to withdraw from the IRA, and distribute to the beneficiary you are seeking to remove, his, her, or its entire share of the benefits, so that, as of the Beneficiary Finalization Date, the remaining beneficiaries of the trust and of the retirement benefits are all individuals (or all younger individuals). See, *e.g.*, PLR 2006-08032; and PLRs 2004-49041–2004-49042, in which the participant left his IRA to a trust that was to be distributed, in specified percentages, to his wife and daughters. The wife took distribution of her percentage of the IRA in full by the Beneficiary Finalization Date (and rolled it over to her own IRA). She was accordingly disregarded in determining who was the oldest beneficiary of the trust, and the older daughter's life expectancy was the ADP for both daughters' shares of the IRA.

Another way is to distribute other assets (not the retirement benefits) to the "undesirable" beneficiary in full payment of his, her, or its share of the trust, so that, as of the Beneficiary Finalization Date, the only remaining beneficiaries of the trust and of the benefits are the "desirable" individual beneficiaries.

Finally, the trustee could transfer 100 percent of the retirement benefits out of the trust, intact, to one or more of the individual trust beneficiaries, before the Beneficiary Finalization Date, so that, as of the Beneficiary Finalization Date, the (young, individual) transferee(s) is (or are) the only beneficiary(ies) of the benefits. The other (older and/or nonindividual) beneficiaries of the trust are disregarded because they and the trust have ceased to have any interest in the retirement benefits (do not "remain" as beneficiaries). However, merely allocating the benefits to one particular share of a trust would *not* be sufficient to allow beneficiaries of other shares of the trust to be disregarded, according to PLRs 2005-28031–2005-28035 (unless that allocation was mandated—see PLR 2006-20026).

B. **Qualified disclaimer by September 30.** If a beneficiary disclaims his entire interest by the Beneficiary Finalization Date, he no longer "counts" as a beneficiary. See ¶ 4.4.11(A). If the disclaimant was the oldest beneficiary, the next oldest beneficiary's life expectancy will become the ADP. Reg. § 1.401(a)(9)-4, A-4(a). See PLRs 2004-44033 and 2004-44034, in which "A" died leaving her IRA to a trust for the life benefit of her sister, with remainder to A's two nieces. The sister (who was older than the nieces) disclaimed her interest in the trust, so that the two nieces became the sole beneficiaries, and the older niece's life expectancy became the ADP. Similarly, disclaiming a power of appointment can eliminate potential appointees who would otherwise be "unidentifiable" and cause the trust to flunk Rule 3 (¶ 6.2.07). See PLR 2004-38044, discussed at ¶ 6.3.11(B).

C. **Other ways to "remove" a trust beneficiary.** The regulation cites distribution and disclaimer as examples of ways in which a person who was a beneficiary as of the date of death could cease to be a beneficiary as of the Beneficiary Finalization Date. Reg. § 1.401(a)(9)-4, A-4(a). ¶ 1.8.03. Certain post-death amendments of the trust, made before the Beneficiary Finalization Date pursuant to express provisions included in the trust instrument, have been recognized by the IRS for RMD purposes; see PLR 2005-37044

(discussed at ¶ 6.3.12(B)). Also, any beneficiary whose rights are terminated prior to the Beneficiary Finalization Date by operation of the trust terms would not be a countable beneficiary:

Axel Example: Axel dies leaving his IRA to a trust which provides that, until his daughter Rose reaches age 35, the trustee will use income and principal for Rose's benefit. When Rose reaches age 35, the trust will terminate and all trust property will pass outright to Rose. If Rose dies before reaching age 35, the trust will terminate and all property will pass to a charity. On the date of Axel's death, Rose is age 34½. Based on the terms of the trust as they exist at Axel's death, the trust has two beneficiaries, Rose and the charity, and "flunks" the RMD trust rules because one beneficiary is not an individual. Six months after Axel's death, Rose turns age 35 and becomes the sole beneficiary of the trust. Since this is before the Beneficiary Finalization Date, the trust qualifies as a see-through trust; the nonindividual beneficiary does not "remain" as a beneficiary as of September 30 of the year after the year of Axel's death.

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

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

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

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

How does the "mere potential successor" rule apply to a trust? For purposes of testing trust beneficiaries for "mere potential successor" status, the world can be divided into two types of trusts: "conduit trusts" (¶ 6.3.05–¶ 6.3.06) and "accumulation trusts" (¶ 6.3.07–¶ 6.3.10).

6.3.05 ***Conduit trusts: Definition, requirements, effects***

"Conduit trust" is not an official term. It is a nickname used by practitioners (and, once, by the IRS; see PLRs 2004-32027–2004-32029) for one type of see-through trust, namely, a trust under which the trustee has no power to accumulate plan distributions in the trust. The IRS regards the

conduit beneficiary as the sole beneficiary of the trust; all other beneficiaries are considered mere potential successors (¶ 6.3.04) and are disregarded.

See ¶ 6.4.04(A) with regard to using a conduit trust for a disabled beneficiary, ¶ 6.4.05(A) for a minors' trust, ¶ 6.4.06(A) for a trust for the benefit of the participant's spouse.

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

The trustee must pay out all distributions the trust receives from the retirement plan, not just "Required Minimum Distributions." As the IRS says in Reg. § 1.401(a)(9)-5, A-7(c)(3), Example 2, "*all amounts* distributed from A's account in Plan X to the trustee while B is alive will be paid *directly* to B upon receipt by the trustee of Trust P… *No amounts* distributed from A's account in Plan X to Trust P are accumulated in Trust P during B's lifetime for the benefit of any other beneficiary." Emphasis added. [Note: The IRS has approved at least one trust which (based on the language quoted in the PLR) specifically required only that *RMDs* (rather than all distributions) be passed out to the beneficiaries; see PLR 2003-29048. This PLR also makes no mention of who were the remainder beneficiaries of the trust. This PLR should not be used as an example, since it does not correctly reflect the regulation and since its analysis of the trust seems incomplete.]

The "conduit" provision must come into effect immediately upon the participant's death. If the conduit requirement does not begin to apply until some later point in time the trust is not a conduit trust. Why not? Because between the date of death and such time the trust may have *already* accumulated plan distributions, so the trust does not meet the definition of a conduit trust at the participant's death.

Shirley Example: Shirley dies leaving her IRA to trust. The trust is to pay income to Shirley's husband Wally for life. After Wally's death the trust is held for the benefit of Shirley's daughter Bonnie, with the trustee required to pay out to Bonnie all distributions the trustee receives from Shirley's IRA. Assuming Wally survives Shirley, this is not a conduit trust, because the conduit provisions do not take effect at Shirley's death. They do not come into effect until the later death of Wally. This trust could qualify as a conduit trust only if Wally predeceased Shirley.

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

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 (¶ 6.3.04) to the conduit beneficiary's interest.

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

C. Conduit trust's provisions after conduit beneficiary dies. As noted above, the "conduit trust" concept rigidly requires that the conduit provisions take effect immediately upon the participant's death. The flip side of that rigidity is the complete flexibility regarding what happens after the conduit beneficiary dies. Since the regulation assumes that 100% of the plan benefits will be distributed out during the conduit beneficiary's life (because it has to be paid out over his/her "life expectancy"), the corollary assumption is that there will be nothing left in the retirement account when the conduit beneficiary dies. Therefore, even if there actually *is* something left in the account when the beneficiary dies, the IRS "doesn't care" what happens to those benefits. The conduit beneficiary is considered the "sole" beneficiary of the benefits and of the trust, so any remainder beneficiary is a mere potential successor and doesn't count. Therefore the remainder beneficiary of the trust can be a noninvidivual (such as a charity), or an older individual, or another trust (even a non-see-through trust), or can be determined by a general power of appointment (see, *e.g.*, PLR 2004-44033), and he, she, or it will be disregarded for purposes of the RMD rules because he, she, or it is a mere potential successor. Since the conduit trust concept *ends* at the death of the original conduit beneficiary, there is no point in continuing "conduit" provisions of any type once the original conduit beneficiary has died.

D. Drawbacks of the conduit trust. The conduit trust is not suitable for every situation, because it lessens the trustee's control considerably. Also, to work as intended, the conduit trust depends upon the minimum distribution rules' staying exactly as they are under present law; if changes in the law require or encourage faster distributions, the trust beneficiary will receive the money much sooner than the participant intended.

There is also the risk that the trust will receive a larger-than-intended distribution by mistake. There are cases where a trustee has requested a small distribution, or even just sent in the paperwork to have the IRA titled as an inherited IRA payable to the trust, and the IRA provider has erroneously cashed out the entire IRA and placed the funds in a taxable account in the name of the trust. One negative effect of such an erroneous distribution is loss of deferral (because a nonspouse beneficiary cannot "roll over" a distribution from an inherited plan, even if the distribution was made in error; see ¶ 4.2.02(A)). The negative effects are compounded if the erroneous distribution is paid to a conduit trust, under which the trustee is compelled to pass out the entire plan distribution to the conduit beneficiary (even if that has the effect of terminating the trust).

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

E. Conduit trust for multiple beneficiaries. When using the conduit trust approach, the well worn path is to have a separate conduit trust for each individual beneficiary. The IRS's only example on point in the regulation deals with a conduit trust for just one beneficiary. However, the principle should also work with multiple beneficiaries. The IRS has at least once approved an apparent conduit trust for multiple beneficiaries; see PLR 2003-29048. To have a conduit trust for multiple beneficiaries, the requirements would be (based on the language in the IRS regulation):

- All distributions the trust receives from the retirement plan must be immediately paid out to one or more of the conduit beneficiaries; and

- As long as any member of the conduit group is living, no plan distributions can be accumulated in the trust for possible distribution to other beneficiaries.

Warren Example: Warren dies leaving his IRA to a trust for his four children all of whom are under age 40. The trust provides that, as long as any child of Warren is living, the trustee must pay out, to one or more of such children, in such proportions as the trustee deems advisable for their education, support, and welfare, any and all amounts the trustee receives from the IRA, upon receipt. The trust terminates when there is no child of Warren living who is under the age of 40, and the IRA is to be transferred in equal shares at that time to such of Warren's children as are then living, or (if no such child is then living), to a charity. Warren's trust "works" as a conduit trust, since only the children can receive benefits from the IRA as long as any child is living.

6.3.06 ***Conduit trust: Administration issues***

Here are practical issues with respect to administration of a conduit trust.

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

B. Payment of trust expenses. In PLRs 2004-32027–2004-32029, the IRS ruled that "The use of Trust T assets to pay expenses associated with the administration of Trust T (in effect, expenses associated with the administration of the Trust T assets for the benefit of [the participant's three children])…does not change" the conclusion that the trust had only individual beneficiaries. The IRS refers to "Trust T" as "a valid, conduit, see-through trust," even though the trust terminated immediately upon the death of the participant and was distributed outright to the participant's three children. In other words, Trust T was not the "classic" conduit trust that remains in existence after the participant's death, passing out all plan distributions to the conduit beneficiary. Nevertheless, since the IRS calls it a "conduit trust," the conclusion that payment of trust expenses out of the retirement plan assets does not adversely affect conduit status should remain valid. In PLR 2006-20026, the IRS blessed a conduit trust under which "asset management fees" would be paid directly to the trustee

of the conduit trust out of the retirement plan assets, and would "not flow through" the trust.

C. **Tracing requirement.** The trustee must show that each distribution received from the plan is paid "directly" to the conduit beneficiary "upon receipt" by the trustee. There is no indication that the trust can take "credit" for distributing to the conduit beneficiary something other than the actual distribution received from the retirement plan.

For example, suppose the minimum distribution from the IRA to a particular conduit trust for a particular year is $10. Early in the year (before taking any distribution from the IRA) the trustee pays $15 to the conduit trust beneficiary (from other assets of the trust). Now the trustee receives the $10 RMD from the IRA. The trustee apparently must pass the $10 IRA distribution out to the conduit beneficiary upon receipt by the trust, even though the trustee has already paid the beneficiary more than that amount during the year in question.

D. **Can plan distributions bypass the trust?** Possibly the trustee could arrange to have distributions sent directly from the IRA or plan to the conduit beneficiary (bypassing the trust's bank account), though presumably the trustee would still have to file a trust income tax return showing it received, and distributed, the retirement plan distributions.

*6.3.07 **Accumulation trusts: Introduction***

Any trust that is not a conduit trust is called in this book an **accumulation trust**, meaning that the trustee has the power to accumulate plan distributions in the trust. The IRS does not use the term "accumulation trust." Under an accumulation trust (except, probably, in the case of a 100% grantor trust; see ¶ 6.3.10) some or all of the potential remainder beneficiaries *do* "count" (i.e., they are not disregarded) for purposes of the RMD trust rules. This is obviously in sharp contrast to a "conduit" trust, under which all beneficiaries other than the conduit beneficiary are disregarded as mere potential successors.

From Reg. § 1.401(a)(9)-5, A-7(c)(1): "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 can be hard to predict which beneficiaries the IRS would say are disregarded as mere potential successors. The meaning of this term is clear in some situations but unclear in others. The regulations offer no other guiding principles and contain only one example of an accumulation trust that passes the rules, the ambiguous Example 1 of Reg. § 1.401(a)(9)-5, A-7(c)(3): "Under the terms of Trust P, all trust income is payable annually to B, 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 B is not the sole beneficiary, but her life expectancy is used as the ADP because she is the oldest beneficiary. This example is defective, however, because it does not explain what happens under "Trust P" *if all of A's children predecease B*. Either the trust document or state law must have something to say on that point, but the IRS's example is silent. Yet the only way we would be entitled to disregard the contingent beneficiaries who take in that case is if they are considered "mere potential successors" (¶ 6.3.04) to the interests of A's children. The ambiguity is repeated in the IRS's use of the same example in Rev. Rul. 2006-26, 2006-1 CB 939.

If we are to use the Example 1 trust as our model for a qualifying nonconduit (accumulation) see-through trust, we must adopt one of the following assumptions or conclusions about the terms of the trust discussed in Example 1 and how the IRS views those terms:

1. Does the trust provide that, if all of the children of A predecease B, the trust will immediately terminate and pass outright to B? If that is what the trust says, then we can safely conclude that all of the potential trust beneficiaries are individuals and B is the oldest of them (because no matter which beneficiary dies when the benefits will pass to B or one or more of A's children), and we have a see-through trust and an ADP.

2. Or, does it *not matter* what the trust says in that case, because we are absolutely entitled to assume that the children of A will survive B, and therefore we can disregard (as mere potential successors) whoever or whatever will take the trust if none of the children of A in fact survive B? If this is the correct interpretation of Example 1, then we can "stop testing" a trust once we arrive at a remainder beneficiary who will take the benefits outright and immediately upon the death of a prior beneficiary. Anyone who might take the benefits if such immediate-outright beneficiaries do *not* in fact survive the prior beneficiary can be disregarded as a mere potential successor.

Interpretation #1 is a "safe harbor"; a trust with such provisions clearly "passes" the rules. Interpretation #2 can also be considered a safe harbor, based on several PLRs blessing that approach. See ¶ 6.3.08(A).

Unfortunately, many trusts are not structured as simply as the trust in Example 1. For example, if the outright distribution to "the children of A" is to be delayed until they reach a certain age, and they have not yet reached that age when A dies, we move into an additional layer of testing difficulty (and seemingly conflicting IRS analyses).

6.3.08 ***See-through accumulation trust ("STAT")***

Under the approach exemplified in the PLRs discussed at "A" below, you test an accumulation trust by "counting" all successive beneficiaries down the "chain" of potential beneficiaries who could take under the trust, until you come to the beneficiary(ies) who or which will be entitled to receive the trust property *immediately* and *outright* upon the death of the prior beneficiary(ies). That "immediate outright" person, entity, or group is (or are) the last beneficiaries

in the “chain” that you need to consider. If the immediate outright beneficiary(ies), and all prior beneficiaries in the “chain,” are individuals, then the trust qualifies as a see-through trust, with the life expectancy of the oldest member of that group serving as the ADP. Any beneficiary who might receive the benefits as a result of the death(s) of such immediate outright beneficiary(ies) is ignored as a “mere potential successor.”

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

See, *e.g.*, PLR 2004-38044, in which benefits were left to a nonconduit trust for the participant’s surviving spouse for life. On her death, the trust would terminate and pass outright to participant’s children if they were over age 30. Since they were already over age 30 when the participant died, they are the last “countable” beneficiaries of the trust, because they would inherit immediately outright on death of the prior beneficiary (the spouse). The trust qualified as a see-through. But many trusts are not that simple. See PLR 2012-03033 for an example of the tortuous process that can be required to analyze a typical family trust for compliance with the IRS’s minimum distribution trust rules.

This type of trust is called a **“See-through accumulation trust” (STAT)** in this book. It is recommended that practitioners use conduit trusts (¶ 6.3.05) and STATs when drafting trusts that are to be named as beneficiary of retirement benefits, since these are the only types of trusts as to which we have clear guidance that they “work.” For how to have a STAT for a disabled beneficiary, see ¶ 6.4.04; for minors, see ¶ 6.4.05; for the participant’s surviving spouse, see ¶ 6.4.06.

However, the IRS has approved, as see-through trusts, accumulation trusts that do not seem to meet the rigid requirements set out here. Thus, though the STAT should be considered a safe harbor, it is apparently not the only type of accumulation trust that can qualify as a see-through trust. See ¶ 6.3.13.

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

At the time of the participant’s death, his spouse survived him, and he had three living children, C, D, and E, and apparently no deceased children. The three children had *already attained age 30* at the time of the participant’s death. Thus, if the spouse had died immediately after the

trust's establishment, the three children would have taken the trust principal (including the remaining retirement benefits) *outright and immediately*.

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

However, the ruling goes on to say that we can stop our search once we reach the children who are the apparent remainder beneficiaries under this trust. Because they will take their shares outright and immediately when the prior beneficiary dies, we do not need to go further and find out who would take the benefits if any of these three children predecease the surviving spouse. From the ruling: "Since the right of each child to his/her remainder interest in the…[trust] was unrestricted at the death of Taxpayer A, it is necessary to consider only Taxpayers B through E [i.e., the spouse and the three children] to determine which of them shall be treated as the designated beneficiary of Taxpayer A's interest in" the retirement plan. (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).

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

B. Finding an "immediate outright" beneficiary (unborn issue don't count). The STAT approach approved in the PLRs discussed at "A" requires the existence of at least one person who is living at the participant's death and who would be entitled to outright distribution of the benefits upon the death of the prior beneficiary(ies). Unfortunately, when drafting a trust, it can be difficult to find a *younger individual* to name as outright immediate beneficiary after the other beneficiary(ies) die(s).

Future unborn issue can NOT be counted for this purpose because you cannot assume they will ever exist. See, *e.g.*, PLR 2008-43042, in which "A" died leaving his IRA to a trust for his son "C." C was to receive all of the trust funds no later than age 40. If C died before reaching age 40, the trust would pass to C's descendants, if any, otherwise to A's "heirs at law." At the time of A's death, C had no descendants living, so if C were to die immediately after his father, the trust would pass to A's heirs. A's sole "heir-at-law-apparent" was his spouse, "B." The IRS ruled that the countable beneficiaries of the trust were C and B, so B was the oldest beneficiary. C's potential future issue did not count. PLRs 2006-10026 and -10027 are similar. For examples of ways in which drafters have tried to work around this problem see ¶ 6.4.08.

6.3.09 ***STAT: "Circle" trust***

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

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

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

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

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

Under the so-called "grantor trust rules," the grantor or beneficiary of a trust, if he holds certain powers or interests, and is a U.S. citizen or resident, will be treated for purposes of the federal income tax as the "owner" of the trust's assets. Though most of the grantor trust rules are aimed at treating the trust creator-donor (the "grantor") as if he still owned the assets he placed in the trust, one of the "grantor trust rules" is actually aimed at the trust *beneficiary* rather than the "grantor": If the trust beneficiary has the sole unrestricted right to withdraw the trust's assets, the trust beneficiary is deemed to be the "owner" of those assets for federal income tax purposes. § 678(a)(1), § 672(f), Reg. § 1.671-3. If an individual U.S. citizen- or resident-trust beneficiary is deemed the owner of all of a trust's assets under § 678(a)(1), then retirement benefits payable to such trust *should* be deemed paid "to" such beneficiary for purposes of the minimum distribution rules, and the "all beneficiaries must be individuals" test would therefore be met. However, there is no ruling on point.

It would be unusual to name, as beneficiary of a retirement plan, a trust that gave its beneficiary the unrestricted right (not subject to anyone's consent, nor to any standard) to withdraw all principal and income from the trust. Anyone wanting to give such broad rights to the beneficiary would presumably leave the benefits outright to the beneficiary rather than in trust. However, this model could be useful for certain disabled beneficiaries (see ¶ 6.4.04(C)) or for a "qualified domestic trust" (QDOT) for the benefit of a noncitizen spouse (§ 2056(d)(2)).

*6.3.11 **Powers of appointment***

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

Under a conduit trust for one beneficiary, the trust's remainder beneficiaries are disregarded. ¶ 6.3.05(B). Thus, the conduit beneficiary (or the trustee or anyone) can be given the power to appoint the trust assets remaining at the conduit beneficiary's death to anyone, even a charity, a non-see-through trust, an estate, or an older individual, and the trust will still qualify as a see-through with the ADP based on the conduit beneficiary's life expectancy. See, *e.g.*, PLR 2006-20026 (conduit beneficiary had general testamentary power of appointment). For a trust with multiple conduit beneficiaries, see ¶ 6.3.05(E).

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

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

B. **Power to appoint to spouses of issue.** A power to appoint property to someone's "spouse" normally triggers the problem of a nonidentifiable beneficiary (unless the power is limited to a particular identified spouse, or to spouses who are younger than the oldest trust beneficiary determined without reference to the power). See Kit and Julia Example, ¶ 6.2.07(A). In PLR 2004-38044, the participant's surviving spouse had the power to appoint the trust at her death to the participant's issue *and their spouses*. To enable the trust to qualify as a see-through, she disclaimed this power. See ¶ 6.3.03(B). As a result of the disclaimer, the property would pass outright at the spouse's death to the takers in default of exercise of the power (the participant's issue).

C. **Power to appoint to charity.** A trust that says "The trustee shall pay income to my spouse for life, and upon my spouse's death the principal shall be paid to such members of the class

consisting of our issue and any charity as my spouse shall appoint by her will," would flunk this rule, because the benefits could pass under the power to a nonindividual beneficiary, the charity.

D. **Power limited to younger individuals.** See ¶ 6.2.07(C).

E. **Power to appoint to another trust.** See ¶ 6.2.12.

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

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

A. **Conduit trust and 678 grantor trust.** If the trust beneficiary has the right to demand distribution of the entire trust to himself, it appears the trust should qualify as a see-through because it is a 100 percent grantor trust (though there is no IRS confirmation of this); see ¶ 6.3.10. A trust also qualifies as a see-through if the trustee is required to pass all plan distributions out to the beneficiary immediately (conduit trust; ¶ 6.3.05). What if the trustee is not required to automatically *distribute* all plan distributions to the beneficiary, but the beneficiary has the right to demand immediate payment to himself of *all distributions the trustee receives from the plan*? The IRS position regarding such a hybrid grantor-conduit trust is not known. Such a trust does *not* conform with the regulation's description of a conduit trust.

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

The benefit gained by this elaboration is the flexibility to cut down on the beneficiary's access to the retirement plan. This flexibility would be desirable if the beneficiary is in financial trouble. But by definition this approach is helpful in this way *only* if the beneficiary gets into trouble during a narrow window of time—either just before the participant's death (too late for the participant to amend his estate plan) or just after it (before the Beneficiary Finalization Date, ¶ 1.8.03, which is the deadline by which the trust protector must exercise the amendment power).

The approach is based on PLR 2005-37044, which involved a trust under which a trust protector had and exercised such an amendment power. The IRS ruled that the exercise of the amendment power did not cause the trust to lose its see-through status, because the trust protector's actions: carried out specific provisions adopted by the participant (i.e., the trust protector did not simply substitute some provisions of its own devising); were effective retroactively to the date of death and so could "be treated as a part of" the original trust instrument; and were "treated as a

disclaimer under the laws of" the applicable state. The finding that state law treated this trust amendment as a "disclaimer" is mysterious because the trust protector's action was not a disclaimer and was nothing like a disclaimer.

Some advisors advocate the "switch" trust as a planning technique, seemingly regarding this single PLR as if it established an IRS-approved prototype trust. An alternative view is that the "toggle" approach involves substantial complications, relying on a single PLR as "precedent," to obtain a modest benefit.

6.3.13 ***IRS rulings that do not conform to these rules***

The IRS approach to testing accumulation trusts for see-through status is not consistent.

The PLRs collected at ¶ 6.3.08 provided in each case a detailed analysis of a trust to determine whether it qualified as a see-through trust, apparently establishing the analysis that would be required to test a trust for see-through status. However, in other PLRs the IRS has approved trusts as see-throughs without going through this arduous process.

There are rulings in which the IRS does not seem to consider all possible "destinations" for the trust assets if (for example) a power of appointment is not exercised (PLR 2002-35038), or whether assets will pass to the next beneficiary outright or in further trust (see, *e.g.*, PLR 1999-03050 discussed at ¶ 6.3.11(A)). In these rulings, unlike in (*e.g.*) PLR 2012-03033, the IRS does not follow the retirement benefits on a hypothetical journey down the chain of beneficiaries until an "immediate outright" beneficiary is reached. Rather the IRS seems to "stop looking" at a much earlier point, when the "primary" or most obvious beneficiary is reached, with incomplete or no regard to what happens to the money if that beneficiary dies, or dies prematurely, etc.

In PLR 2013-20021, the participant died, leaving her IRA to "Trust A." This testamentary trust provided that funds were to be paid to her only child at various ages, with the final payment at age 35. If the child died before reaching age 35, the remaining trust property would pass to the deceased child's issue if any otherwise to the decedent's issue. However, there were no other such issue living when the participant died, and the trust instrument did "not provide for additional contingent beneficiaries for Trust A." But the IRS did not analyze state law to determine *what would become of the retirement benefits if the child-beneficiary died before age 35*. Rather the ruling-writer stated that, since the Trust instrument did not name any beneficiaries beyond the participant's child, there *were no beneficiaries* other than the child, and therefore all the trust beneficiaries were individuals.

This ruling would make sense if, at the time of the participant's death, the participant's child was *already over* age 35, and therefore entitled to immediate outright distribution of the entire trust fund upon her mother's death. In that case, a holding that this child was the sole beneficiary of the trust and therefore of the IRA would make sense and be consistent with prior IRS pronouncements. But the PLR does not say how old the child was when the participant-mother died, creating the impression that, even if the child was under 35, the trust "passed" the rules because no other beneficiaries were named in the trust instrument.

In PLR 2016-33025, P died at age 59 leaving his IRA to a trust. All income of the trust was payable to P's child E for life; in addition, the trustee could make principal distributions to E. The trust was to terminate and be distributed outright to E when she reached age 50. If E died before reaching age 50, the trust would be held for the benefit of E's children F and G, to be distributed to

them outright at age 21. F and G were apparently under age 21 at the time of the ruling, though the ruling does not specifically so state. If these grandchildren of P, having survived E, later died before reaching age 21, the trust property would pass to their "personal representatives" (i.e., their estates), unless E and her children were all deceased at the applicable time, in which case all remaining assets would be distributed to P's siblings, H and I. The questions presented were, did the trust have only individual beneficiaries and if so who was the oldest one.

Under the approach illustrated in PLRs 2004-38044 and 2008-43042 (¶ 6.3.08(B)), this trust would have been analyzed by assuming that E would die before age 50, causing the funds to pass to trusts for grandchildren F and G, and since the grandchildren would not inherit the funds immediately and outright, we would assume they in turn would die before reaching age 21, causing at least the first such grandchild's share to pass to his or her estate (a nonindividual beneficiary), causing the trust to "flunk," or to older individuals, the participant's siblings H and I. However, the IRS did not so rule. Instead, it apparently *ignored* the possibility that the grandchildren could die before age 21 and treated them as if they were "immediate outright" beneficiaries after E's death. Therefore the IRS ruled the sole countable beneficiaries of the trust were E, F and G. In effect the IRS ignored any "wipe-out" beneficiaries who would inherit the trust if the primary and contingent beneficiaries died before reaching ages 50 and 21 respectively. The IRS ignored the possibility that benefits could pass to a grandchild's estate (possibly reasoning that since the estates "didn't exist yet" they could not be counted) or to the older siblings of P.

Some have long argued that the IRS *should* ignore, for purposes of determining who were the beneficiaries of a trust, the possibility that a minor child would not reach the age of majority. Did the IRS adopt that rationale here? Others have argued that a beneficiary's "estate" should not be considered as an "entity" separate from the individual beneficiary; rather, it should be considered "the same as" the individual beneficiary. Was that the rationale for this ruling? There is no way to reconcile this PLR with some of its predecessors, so whether it represents a new direction for IRS policy on these points, or just an aberration, will not be known until further rulings are issued.

One must conclude from these PLRs blessing trusts that did not appear to qualify as see-through trusts under the standards in the PLRs discussed at ¶ 6.3.08 that the definition of a STAT in ¶ 6.3.08 is not the last word. Accordingly, if confronted with a situation in which a decedent's benefits have been left to a trust that does not meet the strict standards stated in ¶ 6.3.08, the practitioner should not despair of getting a favorable IRS ruling on see-through status. For planning purposes, however, there is no way to know at this time whether the nonconforming PLRs indicate that the IRS has relaxed its standards, or whether these PLRs are aberrations (possibly due to facts' not being correctly stated in the ruling, or simply IRS error).

6.3.14 ***Trust beneficiary's death: Effect on ADP***

The "Applicable Distribution Period" (ADP) for an IRA is generally "carved in stone" once the participant dies. We determine who the designated beneficiary(ies) is (or are) at the moment of the participant's death, and that's it. Subsequent events (such as the death of a beneficiary, or the termination of a trust) will have no effect on the ADP—regardless of how many deaths or trust terminations there may subsequently be, the ADP "is what it is" on the participant's death. For details on this rule and its (rare) exceptions, see ¶ 1.5.13.

6.4 Estate Planning Choices

Now that we understand the minimum distribution trust rules (see ¶ 6.2–¶ 6.3), the next step is to see how these rules affect estate planning choices. The comments here also incorporate income tax considerations (see ¶ 6.5).

The first part of this Chapter looks at general planning decisions: Do you care about "see-through trust" status? Should you have a separate trust just for retirement benefits? Are there "boilerplate" provisions to be included in a trust named as beneficiary of retirement benefits?

The second part looks at choices for particular planning situations.

6.4.01 ***Do you care about see-through trust status?***

If retirement benefits are left to a "see-through trust" (¶ 6.2.04), the benefits can be distributed in annual instalments over the life expectancy of the oldest trust beneficiary, just as if the benefits had been left to an individual human Designated Beneficiary. In contrast, if the trust does not qualify as a see-through trust under the rules explained in ¶ 6.2–¶ 6.3, the retirement benefits must be distributed under the "no-Designated-Beneficiary" (no-DB) rules. The no-DB rules require that all sums be distributed out of the plan within approximately five years after the participant's death, if the participant died *before* his required beginning date (RBD) (¶ 1.5.06); or (if the participant died *after* his RBD) over the remainder of what would have been the participant's life expectancy. ¶ 1.5.08. Distribution over the life expectancy of a beneficiary often provides longer deferral than distribution under the no-DB rules.

The fact that a trust qualifies as a see-through trust does not mean that the trust is the best choice as beneficiary of the retirement benefits. For example, making benefits payable to a trust of which the participant's surviving spouse is the life beneficiary results in substantially less deferral than would be available (via the spousal rollover) for benefits left to the spouse outright even if the trust qualifies as a see-through; see ¶ 3.2.01. Also, benefits left to a trust may be subjected to high trust income tax rates (¶ 6.5.01), even if the trust qualifies as a see-through.

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

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

- **Client's goals; beneficiaries' needs.** It may be appropriate to sacrifice the deferral possibilities of the life expectancy payout method in order to realize the client's other goals. 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 may be no point in making the trust qualify as a see-through.

- **Trust beneficiary older than participant (plans that permit stretch payouts).** If the participant dies after his RBD, leaving benefits to a see-through trust, the ADP is the life

expectancy of the participant or of the oldest trust beneficiary, whichever is longer. If the trust is not a see-through, the ADP is the participant's life expectancy. If the participant is past his RBD, and the oldest trust beneficiary is the same age as (or older than) the participant, the ADP will be the same whether or not the trust qualifies as a see-through. Thus, qualifying as a see-through trust is generally 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. The exception: If the plan in question pays death benefits only in the form of a lump sum, a trust-named-as-beneficiary will have to qualify as a see-through trust *even if* the participant died after his RBD and was younger than (or the same age as) the oldest trust beneficiary, IF the trust wants to stretch distributions over the participant's remaining life expectancy. The trust will be able to use that "short stretch" payout only if it can have the lump sum transferred out of the lump-sum-only plan by direct rollover to an inherited IRA; and the nonspouse beneficiary rollover option is available only to individual beneficiaries and *see-through* trusts. See ¶ 4.2.04(C) .

- **Charitable trust.** Passing the trust rules is irrelevant for an income tax-exempt charitable remainder trust; see ¶ 7.5.04 .

- **Lump sum is best form of distribution.** There is no need to comply with the RMD trust rules if the trust qualifies for and plans to take advantage of a lump sum distribution income tax deal such as that available for "net unrealized appreciation" (NUA) of employer stock or for a participant born before 1936. See ¶ 2.4–¶ 2.5.

6.4.02 ***Boilerplate provisions for trusts named as beneficiary***

The RMD trust rules do not require the trust instrument to specify that the trustee must withdraw the annual RMD from the retirement plan. § 401(a)(9)(B) requires the RMD 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 RMD in the trust instrument, because it doesn't hurt to remind the trustee that he is supposed to comply with the minimum distribution rules. Also, including language dealing with the minimum distribution rules makes it clear that the drafter was aware of these rules and that the dispositive terms of the trust are not meant to conflict with them. In a marital deduction trust (¶ 3.3.02) 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 RMD.

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

Avoid tying trust distributions too tightly to the minimum distribution rules, which could result in the beneficiary's receiving more or less than the trust-grantor envisioned if the minimum distribution rules are changed. This happened when (now repealed) § 401(a)(9)(H) suspended Required Minimum Distributions for the year 2009. Under a trust that permitted the trustee to

distribute to the beneficiary only the "required" distribution and nothing else, the beneficiary received no distributions at all in 2009.

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

Similarly, consider including provisions that: the trust will be irrevocable at the participant's death (¶ 6.2.06); certain adult adoptions occurring after the participant's death will be ignored (¶ 6.2.07(A)); and property may not be transferred to a non-see-through trust (¶ 6.2.12). However, do not conclude that a trust that includes these "boilerplate" provisions automatically qualifies as a see-through trust, eligible to take minimum distributions based on the life expectancy of the oldest of beneficiary; that is absolutely not the case. Qualification as a see-through trust depends on the substantive terms of the trust. A trust that provides "income to my spouse for life, remainder to Charity X," can not qualify as a see-through trust because of the "countable" nonindividual remainder beneficiary (the charity). Including a paragraph in such a trust to the effect that "retirement benefits cannot be paid to any nonindividual beneficiary" does not fix the problem; it just makes the trust even more defective because now (in this example) the remainder interest in the trust is not disposed of (and may therefore revert to the donor's estate, another nonindividual beneficiary). See "Heather Example" at ¶ 7.3.03.

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

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

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

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

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

Here are the options (A–D) available for a trust that is to be named as beneficiary of a retirement plan and that is intended to provide for a disabled beneficiary. Which option is best

depends on whether the beneficiary must qualify for need-based government benefit programs, how important it is to qualify as a see-through trust, income tax rates of the trust and beneficiary(ies), and who will be the remainder beneficiary. If qualification for benefit programs is a goal, the donor should consult with an attorney who specializes in drafting this type of trust. If the participant has *already died* and left benefits *outright* to a disabled beneficiary, see "E."

A. **Conduit trust.** Under a conduit trust (¶ 6.3.05), all of the RMDs, as well as any other distributions the trustee receives from the retirement plan, would have to be distributed to (or applied for the benefit of) the beneficiary. If such distributions are passed out to the disabled beneficiary, they would be considered available income or assets to the beneficiary, thus potentially impairing eligibility for welfare benefits. Thus, a conduit trust is normally not suitable to be named as beneficiary for a disabled individual if the goal is to retain eligibility for welfare-type disability benefits. If qualification for such benefits is not an issue (for example, because the family intends to provide for all of the beneficiary's care), a conduit trust could be suitable, especially if the donor wants the trust to qualify as a see-through trust and to have the remainder interest pass to charity.

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

Note: The question of whether a trust needs to comply with the RMD trust rules applies only to trusts created by the retirement plan participant for the benefit of a disabled beneficiary. A trust created by the disabled beneficiary him or herself (a self-settled special needs trust, also called a "(d)(4)(A) trust") *never* needs to comply with the "RMD trust rules." See "E."

B. **See-through accumulation trust (STAT); qualified disability trust.** Under most forms of "supplemental needs" trusts (designed to benefit a disabled beneficiary without causing loss of the beneficiary's eligibility for need-based government programs), the trustee has discretion regarding whether to distribute trust funds to or for the benefit of the disabled individual, but is prohibited from distributing funds for expenses that are paid for by the government programs such as support and medical care. Such a trust would be considered an accumulation trust for RMD purposes, but would still qualify as a see-through *if* the trust passes outright at the disabled beneficiary's death to other now-living individuals, such as the disabled beneficiary's siblings; see ¶ 6.3.08 and, *e.g.*, PLR 2001-09051 (30% share). If see-through trust status is desired, a charity cannot be named as remainder beneficiary of the accumulation trust.

For see-through trust status, ideally, the remainder beneficiaries should be one or more individuals who are close in age to (or younger than) the disabled beneficiary; for example, siblings might typically fit this description. The countable trust beneficiaries will then be the disabled person and the individuals who will inherit (outright and immediately) whatever is left in the trust (and retirement plan) on the death of the disabled individual. The life expectancy of the oldest member of this group will be the ADP. Thus, drafting this type of trust is "easy" if there are siblings (or other suitable individual remainder beneficiaries) who are (1) living at the participant's death and (2)

younger than or close in age to the disabled beneficiary—but impossible if there are no such suitable younger or close-in-age individual remainder beneficiaries.

Thanks to Elder Law expert Stephen J. Silverberg, Esq., for the following point: If the trust is also a "**qualified disability trust**," there would be additional advantages. Net income from a qualified disability trust is considered "earned income" of the child-beneficiary for purposes of the rule that *un*earned income of children under a certain age is taxed at a special tax rate ("kiddie tax"). § 1(g)(4)(C), (j)(4). This is in favorable contrast to the treatment of retirement benefits paid directly to a child-beneficiary, which are considered *un*earned income. Reg. § 1.1(i)-1T, A-9. Also, a qualified disability trust may be entitled to a higher exemption for federal income tax purposes: $2,000 for years prior to 2018, $4,150 for years 2018-2015, adjusted for inflation after 2018. See § 642(b)(2)(C) for the special exemption rule and the definition of qualified disability trust.

C. **Accumulation 100 percent grantor trust.** A trust that gives the beneficiary the unlimited right to withdraw all the trust property at any time would be treated as a 100 percent grantor trust (¶ 6.3.10). It could be a suitable way to provide for a mentally handicapped beneficiary who (1) does not need to qualify for need-based government benefits (because this type of trust would disqualify him) and (2) can exercise the right of withdrawal only through a legal guardian, especially if the guardian is also the trustee. For this type of beneficiary, this type of trust provides the benefits of a discretionary trust while (presumably; see ¶ 6.3.10) allowing the life expectancy of the handicapped beneficiary to be the ADP. It also allows distributions to be taxed at the beneficiary's tax rate. This approach can be particularly helpful if the beneficiary has no siblings or issue, where the only likely remainder beneficiaries are either much older individuals, the beneficiary's own estate, or charities.

D. **Charitable remainder trust with payments to special needs trust.** If the donor is charitably inclined, consider making the retirement benefits payable to a charitable remainder trust (CRT; see ¶ 7.5.04) for the life benefit of a "financially 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 (similar to a "(d)(4)(A)"-type special needs trust; see "E") for the disabled beneficiary rather than outright to him (as is normally required for CRTs). The beneficiary's disability and the trust must meet various requirements, including payment of any remaining trust principal to either the disabled beneficiary's own estate, to the state in repayment of benefits paid to him, or pursuant to the disabled beneficiary's exercise of a general power of appointment, according to Rev. Rul. 2002-20, 2002-1 CB 794.

E. **If the participant has already died.** Options A–D above apply during the planning stage, while the participant is alive and is trying to choose the best type of trust to name as beneficiary. If the participant has *already died*, and left the benefits *outright* to a disabled beneficiary, and qualification for government benefits is a concern, the disabled beneficiary's guardian could seek to have the benefits transferred to a "(d)(4)(A)" trust for the disabled beneficiary, as was done in PLRs 2006-20025 and 2011-16005. These rulings treated a beneficiary's transfers of an inherited IRAs into a self-settled special needs trust as a nontaxable event, provided there was no gift involved (see ¶ 6.1.06).

In drafting a self-settled special needs trust to receive an inherited IRA by transfer from the named individual beneficiary, qualification as a see-through trust is NOT a concern. Because the benefits were left *outright* to an individual (the "Designated Beneficiary"; see ¶ 1.7.03), the benefits have *already* qualified for the life expectancy payout. See-through status is a concern when drafting a trust only when the *participant leaves benefits to a trust*, not when a beneficiary who has inherited benefits outright subsequently *transfers* such benefits to a trust.

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

Here are the options available for a trust intended to provide for minor beneficiaries, when qualifying for see-through trust status is an important goal (¶ 6.4.01). In deciding which to use, consider the donor's objectives: Is the donor's main goal to be sure that the "stretch" payout method is available? Or is the money most likely to be spent during the beneficiaries' childhood, for their education and care, rather than conserved for the beneficiaries' own retirement years? Also consider the value of the benefits and other assets: Are the benefits and nonbenefit assets each substantial enough to justify establishing separate trusts, one for the benefits and one for the other assets (see ¶ 6.4.03)? Are the benefits substantial enough to justify establishing a separate trust for each minor beneficiary, or is the "family pot trust" approach better (see "F")?

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

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

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

Emily Example. Aunt Emily believes that leaving her IRA to her young nephew is a fine way to provide him with a nest egg, but knows that, if she names him directly as beneficiary, he will cash out the account immediately upon her death. So she leaves the IRA to a conduit trust for him. ¶ 6.3.05. The purpose of the trust is to make sure her nephew takes advantage of the "life expectancy payout," whether he wants to or not, and to provide professional management for the undistributed portion of the IRA. The nephew's support and education are paid for by his wealthy parents. The trustee is instructed to withdraw from the IRA, each year, the RMD (based on the nephew's life expectancy) and distribute it to the nephew. Alternatively Aunt Emily could use an IRT (¶ 6.1.07).

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 (¶ 6.3.05(B)) and because they expect that the RMDs 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 (long life expectancy). A conduit provision for the retirement benefits "inside" another trust (see ¶ 6.4.03) may also be a good way to leave

benefits to minors if the retirement benefits are not substantial enough to justify establishing a separate trust. The benefits are left to the same trust as all the other assets, but that trust contains "conduit" provisions requiring the trustee to pass through all retirement plan distributions.

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

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

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

C. STAT: Who will be the now-living outright, immediate, remainder beneficiary? To avoid using a conduit trust, and still qualify as a see-through, practitioners look for ways to make the minors' trust a see-through accumulation trust or "STAT" (¶ 6.3.08).

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

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

Typically, the donor of a minors' trust would name a "wipeout" beneficiary, to take the trust property if all of the minor children die without issue while there is still money in the trust. The problem is, if the wipeout beneficiary is a charity or other nonindividual, the trust will flunk Rule 5

(¶ 6.2.09); and if the wipeout beneficiary is an individual who is older than the oldest minor child, the wipeout beneficiary's shorter life expectancy will be the ADP (¶ 6.2.07).

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

What the IRS Should do

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

Here are some possible approaches for dealing with this problem:

- One approach is for the donor to plug in the name of a younger individual as the wipeout beneficiary, perhaps a young niece, nephew, or other relative. The drawback of this approach, obviously, is that the donor ends up potentially leaving the retirement benefits to someone he is not really interested in benefitting.

- Another approach, used successfully in PLR 2002-35038, is to give the trustee (or a beneficiary) the power to distribute (or appoint) the remainder to any individual beneficiary who was born in the same year as the donor's oldest child or in a later year (or give the minor children the power to appoint to any younger beneficiaries). Unfortunately, the IRS's rulings approving this approach are seriously defective, in that the rulings fail to mention what would happen to the benefits if the power of appointment were not exercised. Realistically, the trust instrument would still have to name a younger individual wipeout beneficiary to address this possibility.

- A third approach is to name, as the wipeout beneficiary, heirs at law who are younger than the oldest "real" beneficiary; see ¶ 6.4.08.

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

E. Staged distributions at various ages. Trusts for minors often provide for a staged distribution of principal, *e.g.*, half at age 25, balance at age 30. Such staged distributions create several headaches when the trust is beneficiary of a retirement plan. One is whether a retirement benefit is an asset of the trust that is capable of being valued and divided; while many practitioners assume the answer is "yes" with respect to an IRA (which is normally a mere custodial account holding easily-valued securities), the answer is less obvious for a nonassignable benefit under a traditional pension plan.

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

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

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

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

The main drawbacks of leaving benefits to a custodian under UTMA are that the beneficiary becomes entitled to the money outright at a certain age (typically 18 or 21, depending on state law), and that age may be younger than the age the parents would ideally like. Also, the benefits must be left to specific individuals (such as, typically, equal shares to the surviving children). You lose the

flexibility of leaving benefits to a "family pot" trust where the trustee has discretion to spend more for one child than another depending on their needs.

The IRS has never ruled on the question of who is considered the Designated Beneficiary when benefits are paid to a custodian under UTMA. 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 (presumably including retirement plan distributions) paid to the custodian is taxable income of the minor except to the extent it is used to discharge someone else's legal obligation to support the minor. Rev. Rul. 59-357, 1959-2 CB 212. If leaving benefits to a custodian for a minor, check applicable state law for format required, eligible custodians, and age at which the custodianship terminates.

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

Here are options to consider for a trust intended to provide life income to the participant's surviving spouse, including a credit shelter or QTIP trust, when qualifying for see-through trust status is an important goal (¶ 6.4.01). Before naming a trust as beneficiary, be sure the client understands the income tax drawbacks of leaving benefits to a trust for the spouse as opposed to outright to the spouse. If qualifying for the marital deduction is important, see ¶ 3.3.0 and ¶ 3.3.0 . See also ¶ 7.5.06(C) regarding use of a charitable remainder trust for the spouse's life benefit.

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

The primary *drawback* of a conduit-credit shelter trust is that, if the spouse lives long enough, RMDs 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.

Prior to 2011, a married couple who had enough wealth to be concerned about federal estate taxes, but had most of their assets in the form of retirement benefits, faced an unpleasant choice upon the first spouse's death: The first spouse's retirement benefits could be left to a credit shelter trust to minimize estate taxes, but at the cost of losing the income tax benefits of the spousal rollover...or the benefits could be left outright to the surviving spouse (to get the income tax benefits of the spousal rollover), at the cost of "wasting" the first spouse's estate tax exemption (which would disappear to the extent not used at his/her death, under the pre-2011 use-it-or-lose-it system). Since 2011, the availability of "portability" of the federal estate tax exemption between spouses eliminates this harsh choice. With portability, the first spouse to die can leave his or her retirement benefits outright to the surviving spouse (who can them roll them over to maximize income tax benefits) and *also* leave his/her federal estate tax exemption amount to the surviving spouse (so the exemption of the first spouse to die is not wasted). The need to leave retirement benefits to a credit shelter trust for estate tax reasons has been greatly reduced if not eliminated.

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

Conduit Trust Ironies

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

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

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

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

B. **Accumulation STAT.** The typical QTIP or credit shelter trust is an accumulation trust (¶ 6.3.07), meaning that the remainder beneficiaries "count" for purposes of the all-beneficiaries-must-be-individuals rule and the oldest-beneficiary's-life-expectancy-is-the-ADP rule. See ¶ 6.3.08(A).

If the trust is to terminate and pass immediately outright to the participant's issue on the spouse's death, the trust will "pass" the rules as a STAT *provided* that at least one issue of the participant survives the participant; if those conditions are met, the trust can provide whatever the participant wants it to provide regarding disposition of the trust assets if all the issue later predecease the spouse. ¶ 6.3.08. If using this format, it is advisable to name the issue *directly* as contingent beneficiaries of the retirement plan if the spouse does not survive the participant. See ¶ 6.3.02.

C. Accumulation trust: Shares for issue held until certain ages. If the trust does not pass immediately outright to the participant's issue upon the surviving spouse's death, but rather is to be held in trust for some or all of the issue until they reach certain ages, the trust will not qualify as a STAT 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. See ¶ 6.3.08(C), but see also ¶ 6.3.13. Having the trust "convert" at the spouse's death to conduit trusts for the issue will NOT work; see ¶ 6.3.05(A).

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

6.4.07 ***Generation-skipping and "perpetual" trusts***

The RMD trust rules pose challenges when a client seeks to adopt a multi-generation or perpetual trust (for example, to take advantage of the client's "generation-skipping transfer" (GST) tax exemption; see § 2601–§ 2664). A client may have the erroneous idea that a trust named as IRA beneficiary can somehow "stretch out" the IRA distributions perpetually over the ever-longer life expectancies of succeeding generations, but it is not possible to do that. See ¶ 6.3.14.

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

Leaving the benefits directly to grandchildren outright, or to conduit trusts for the benefit of "skip persons," poses no particular problems. If benefits are left to an "accumulation trust" (¶ 6.3.07) for the benefit of the participant's descendants, the problem from the point of view of "passing" the RMD trust rules is to name an individual beneficiary who will receive the trust assets immediately, outright, on the death of one or more prior beneficiaries. One way to accomplish this is to use the "last man standing" approach so that, if at some time in the future there is only one issue of the participant living, the trust terminates and is distributed to that one individual at that time; see ¶ 6.3.09. The other is to provide that, if *all* of the participant's issue die while there is still money in the trust, the trust will pass to the persons who would have been the participant's heirs at law who are younger than the oldest trust beneficiary; see ¶ 6.4.08.

For the record, here are some questions repeatedly received on this topic:

As long as minimum distributions are made over the life expectancy of a specified trust beneficiary, why does the IRS care who actually gets the benefits? *Answer:* Because the Code specifies that the distribution period is the life expectancy "of the beneficiary" of the benefits—not "of some randomly selected individual." That is why the IRS "cares"—they are required to carry out the law enacted by Congress.

Why doesn't the IRS make it easier for my wealthy clients to leave their retirement benefits to a perpetual trust so they can defer income taxes on the benefits AND eliminate several generations' worth of estate taxes on this money? *Answer:* The purpose of the tax incentives associated with retirement benefits is to help individuals save for their retirement. The idea presumably was that plan participants would spend all or most of this money in their old age. The real question is why does the Tax Code ever allow multi-decade deferral of distributions beyond the death of the participant?

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

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

However, a general power of appointment at death requires that the child have the ability to appoint the trust to the child's estate, which is a nonindividual. § 2041(b)(1). Thus, if the child has a general power of appointment at death, and the trust is not a conduit trust, the nonexempt share trust may flunk the RMD trust rules (because a potential remainder beneficiary, the child's estate, is not an individual); but see PLR 2016-33025 (¶ 6.3.13), in which the IRS seemed to ignore a beneficiary's "estate" as a potential remainder beneficiary.

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

6.4.08 "Younger heirs at law" as "wipeout" beneficiary

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

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

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

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

6.5 Trust Income Taxes: DNI Meets IRD

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

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

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

This section deals extensively with **income in respect of a decedent (IRD)**. For definition and basic rules of IRD, see ¶ 4.6.

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

When retirement benefits are distributed after the participant's death to a trust that is named as beneficiary of the retirement plan or account, the distribution is includible in the trust's gross income just as it would have been included in the gross income of an individual beneficiary (see Chapter 2). § 641(b).

Qualifying as a "see-through trust" under the minimum distribution rules (¶ 6.2.04) makes no difference to the trust's income tax treatment. See-through trust status matters only for purposes of determining when the trust must take distribution of the benefits; it has no effect on the tax treatment of those distributions once they arrive in the trust's bank account.

There are several differences between trust (fiduciary) income taxes and individual income taxes. On the negative side, trusts are generally in a higher income tax bracket than human beneficiaries. Balancing this negative, trusts are entitled to deductions not allowed to individual taxpayers.

A trust (unless its existence as a separate entity is ignored under the "grantor trust rules"; ¶ 6.3.10) or estate is a separate taxpayer and pays tax on its taxable income at the rate prescribed for trusts and estates. A trust or estate goes into the highest tax bracket (37%) for taxable income in excess of $12,500 (2018 rates). For a single individual, the top income tax bracket applies only to taxable income above $500,000 for 2018. Thus, in all but the wealthiest families, income paid to a trust will be taxed at a higher rate than would apply to the individual family members, unless the high trust tax rates can be avoided or mitigated by one of the following means:

- **Pass income out to individual beneficiaries.** A trust is entitled to an income tax deduction for distributions it makes from the trust's "distributable net income" (DNI) to *individual* trust beneficiaries, if various requirements are met. See ¶ 6.5.02.

- **Charitable deduction.** A trust is entitled to an income tax charitable deduction for certain distributions it makes to *charity*. See ¶ 7.4.03 .

- **Transfer the retirement plan to a beneficiary.** A trust can transfer the retirement benefits, intact, to the trust beneficiary. ¶ 6.1.05. Following such a transfer, distributions will be made directly to the former trust beneficiary and (in most cases) taxed directly to such former trust beneficiary. See ¶ 6.5.07–¶ 6.5.08.

- **Grantor trust rules.** If the individual trust beneficiary is a U.S. citizen or resident, and has the unlimited right to take the retirement benefits out of the trust, the trust is considered a "grantor trust" as to that beneficiary, and distributions from the retirement plan to the trust would be gross income of the beneficiary rather than of the trust. ¶ 6.3.10.

- **Qualified disability trust.** If the trust is a "qualified disability trust," a portion of its otherwise-taxable income may be tax-exempt. See ¶ 6.4.04(B).

- **Use the IRD deduction.** If the participant's estate was liable for federal estate taxes, the trust gets an income tax deduction for the estate taxes paid on the retirement benefits. See ¶ 6.5.04.

*6.5.02 **Trust passes out taxable income as part of "DNI"***

A trust gets a unique deduction on its way from "gross income" to "taxable income": The trust can deduct certain distributions it makes (or is required to make) to the trust's beneficiary(ies)

(other than charities; for tax treatment of distributions from a trust to a charity, see Chapter 7). § 651, § 661. These distributions are then includible in the beneficiaries' gross income. § 652, § 662(a). The trust's income tax deduction is limited to the amount of the trust's **distributable net income** or **DNI** (§ 651, § 661), so this is usually called the "**DNI deduction**."

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 can be a bit complicated.

First the good news: Retirement plan distributions that are received by a trust and are includible in gross income, become (like other items of IRD) part of the trust's DNI. See definition of DNI at § 643(a); Reg. § 1.663(c)-5, Examples 6, 9, and 10; 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); Reg. § 1.662(a)-3.

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

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

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

A. **Trust must authorize the distribution.** The DNI deduction will not be available unless the beneficiary is entitled to receive the money; thus, obtaining this deduction requires attention at the trust drafting stage. See ¶ 6.5.03.

B. **Income must be required to be, or must actually be, distributed, in year received.** The DNI deduction is available only for gross income that either is required to be distributed, or is actually distributed, to the individual beneficiary *in the same taxable year it is received by the trust* (or within 65 days after the end of such taxable year, if the trustee elects under § 663(b) to have such distribution treated as made during such taxable year). § 651(a), § 661(a). Thus, in the case of *discretionary* distributions, the trustee must take action prior to the deadline; if no one considers the problem until it is time to prepare the trust's tax return, it will be too late.

C. **Allocation of DNI when separate share rule applies.** If there are two or more beneficiaries, and they have "substantially separate and independent shares," a distribution to one beneficiary will not carry out DNI that is allocated under the "separate share rule" to a different beneficiary. See ¶ 6.5.05–¶ 6.5.06 for how this rule applies to retirement benefits.

D. **Transfer of the plan does not carry out DNI.** Though a distribution *from* a retirement plan *to* a trust is IRD, and becomes part of DNI, the retirement *plan* itself, which is a "right to receive IRD," is outside the normal DNI rules. Accordingly, transferring the *plan itself* to the beneficiary generally does not "carry out DNI." See ¶ 6.5.07–¶ 6.5.08.

E. **No DNI deduction for distribution to charity.** The trust generally does not get a DNI deduction for distributions to charity. § 651(a)(2), § 663(a)(2).

F. **No DNI deduction for certain pecuniary bequests.** Finally, the DNI deduction is not available for distributions in fulfillment of a bequest of a specific sum of money ("straight" pecuniary bequest) unless the governing instrument requires that such distribution is to be paid in more than three instalments (which would be unusual). § 663(a)(1), Reg. § 1.663(a)-1. Thus a trustee's distribution in 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." 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—for example because the exact amount of the bequest will depend on such things as whether the executor elects to deduct administrative expenses on the estate tax return or on the income tax return. Reg. § 1.663(a)-1(b)(1). See PLR 2002-10002 for an example of a formula pecuniary "credit shelter" bequest, fulfilment of which with IRA distributions "carried out DNI" to the beneficiaries.

Soroya Example: Soroya leaves her $10 million IRA to the Soroya Living Trust. The trust provides that, upon Soroya's death, the trustee shall distribute to the Bypass Trust the maximum amount that can be left to beneficiaries other than Soroya's spouse or charity without incurring a federal estate tax, and shall distribute the balance of the trust property to Soroya's surviving spouse. The combined federal and state income tax rate applicable to the trust is 45 percent. The dollar amount payable to the Bypass Trust under Soroya's funding formula turns out to be (after applying the formula, accounting for all deductions, etc.) $3.5 million. The trustee of the Living Trust withdraws $3.5 million from the IRA and distributes it to the Bypass Trust. The Living Trust has $3.5 million of gross income, and it gets a DNI deduction of $3.5 million, so the Living Trust has no income taxes to pay. The Bypass Trust is now funded with $3.5 million all of which is included in the Bypass Trust's gross income as DNI. The balance of the IRA ($6.5 million) is transferred by the Living Trust (¶ 6.1.05) to Soroya's widower in fulfilment of his residuary marital share; this transfer is nontaxable.

*6.5.03 **Trust must authorize the distribution***

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

If the trust instrument requires the trustee to distribute to the individual trust beneficiary(ies) 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); Reg. § 1.662(a)-3.

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

Paul Example: Paul leaves his IRA to a credit shelter trust that requires the trustee to pay all income of the trust to Paul's wife for life, and hold the principal in trust for distribution to Paul's issue upon his wife's death. The trustee receives a Required Minimum Distribution (RMD) from the IRA. Under the state law applicable to Paul's trust, 10 percent of the RMD 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 RMD to Paul's wife; the other 90 percent must be retained in the trust, and will be taxed at trust income tax rates. Even if the trust says the trustee can distribute principal to Paul's wife "if her income is not sufficient for her support," the trustee cannot give her more than the 10-percent "income" amount unless she actually needs more for her support.

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. To have the trust be *forced* to take advantage of this deduction, see "conduit trusts" at ¶ 6.3.05.

6.5.04 ***Trusts and the IRD deduction***

The recipient of income-taxable inherited retirement benefits is entitled to an income tax deduction, called the "income in respect of a decedent" or "IRD" deduction, for federal estate taxes paid on the benefits. For how to compute the deduction and when it may be taken, see § 691(c) and ¶ 4.6.04–¶ 4.6.08.

If a retirement plan distribution to the trust is IRD when received, the trust is entitled to the applicable § 691(c) deduction, 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. If the IRD is not passed out to the trust beneficiaries in DNI, then the IRD and the IRD deduction stay in the trust.

For how the deduction is allocated under a *charitable remainder trust*, see ¶ 7.5.05(C).

The deduction for federal estate taxes paid on IRD is an itemized deduction. Though not a "miscellaneous itemized deduction" (subject to the restrictions imposed by § 67), it is subject to reduction under § 68 in years when § 68 is applicable. Although § 68 does not apply to individuals in the years 2018–2025, it *never* applies to trusts or estates. § 68(e). This creates some incentive for a participant whose estate will be subject to federal estate taxes to name a trust or estate as beneficiary of income-taxable benefits, and for a see-through trust named as beneficiary of income-taxable qualified plan benefits to do a Roth conversion of such benefits (¶ 4.2.05(B)).

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

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

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

Separate Accounts vs. Separate Shares

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

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

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

Jody Example: Jody dies in Year 1, leaving his $1 million IRA, $1 million of real estate, and $1 million of marketable securities to a trust. At Jody's death, the trust is to be divided into two equal shares, one for each of Jody's children Brad and Angelina, so each child is to receive a total of $1.5 million. Each child's share is to be distributed outright to the child upon attaining age 35. Angelina is already age 36; Brad is 33. In Year 1, the IRA administrator sends the trustee a check for the entire IRA balance of $1 million, creating $1 million of gross income to the trust. The trustee immediately distributes the $1 million it received from the IRA 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 must be made "in substantially the same manner as if separate trusts had been created" for them. Reg. § 1.663(c)-3(a). If this had been a "spray" trust, with the trustee having discretion to pay income and/or principal of the entire fund to either child at any time (instead of having to give each child an equal amount) the separate share rule would not apply.

Step 2: Is the plan distribution corpus? The regulation next requires that we determine whether the IRA distribution 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 IRA 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 IRA to Angelina's share, then all the income arising from the IRA distribution is allocated to Angelina's "separate share" and the $1 million cash distribution from the trust carries out $1 million of DNI to Angelina. Reg. § 1.663(c)-5, Example 9.

Allocation Respected Despite No Economic Effect

Under the regulation, a trust instrument's allocation of a retirement account or its proceeds (typically wholly or largely IRD) 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). In contrast, the regulations give effect to the allocation of a particular "class" of income to one beneficiary or another "only to the extent that it has an economic effect independent of the income tax consequences of the allocation." See Regs. § 1.643(a)-5(b) and § 1.642(c)-3(b) (with respect to charitable beneficiaries) and Reg. § 1.652(b)-2(b) (other beneficiaries).

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

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

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

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

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

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

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

- **Transfer the plan itself, rather than a distribution.** In the Jody Example, the trustee could transfer the IRA itself to Angelina, rather than withdrawing money from the IRA and distributing the money to Angelina. See ¶ 6.1.05. Such a transfer generates no gross income at the trust level and accordingly the separate share rule for allocation of DNI never comes into play. The problem of Reg. § 1.663(c)-2(b)(3) is avoided. See ¶ 6.5.07.

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

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

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

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

However, this general rule does not apply to a "transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent." § 691(a)(2) (second sentence). Thus, when a retirement benefit is transferred out of an estate or trust to a beneficiary of the estate or trust, the transferring entity is not taxed on the transfer (for exception see ¶ 6.5.08). Instead, the transferee is taxable on the IRD as and when it is paid to such transferee. § 691(a)(1)(C); Reg. § 1.691(a)-4(b)(2), (3).

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

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

A. **Transfer from trust to trust beneficiary.** If the right-to-receive IRD is distributed as a specific bequest from a trust, or upon termination of the trust to a residuary legatee, the beneficiary who is entitled to the item, and not the trust, bears the income tax. Reg. § 1.691(a)-2(a)(3); § 1.691(a)-4(b)(3); PLRs 2008-03002, 2008-26028, 2010-13033.

What if the right-to-receive is transferred to a trust beneficiary under a discretionary power to distribute principal, but the trust is ongoing? Although the regulation refers to a "terminating" trust, the exception applies to any properly authorized transfer from the trust to its residuary beneficiaries, which is in effect a termination of the trust with respect to such asset. See PLR 2005-26010.

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 9537011; and 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 (IRAs and 403(b) plans), 2006-17020, and 2006-33009; 2006-18023 (nonqualified annuity transferred to residuary beneficiaries); 2008-50004; and 2008-50058.

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

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

¶ 6.5.07 dealt with the transfer of a retirement plan, intact, to a trust or estate beneficiary in fulfilment of a *specific* or *residuary* bequest. In Chief Counsel Advice (CCA) 2006-44020, the IRS addressed the tax consequences of a trustee's transferring an IRA to a beneficiary to fulfill a *pecuniary* legacy. The Chief Counsel advised that the trustee's assignment of an interest in an IRA to a trust beneficiary in satisfaction of a pecuniary gift triggered realization of income at the trust level under § 691(a)(2). Citing *Kenan v. Commissioner*, 114 F. 2d 217 (2d Cir. 1940), the IRS said

the trust "has received an immediate economic benefit by satisfying its pecuniary obligation to the Charities with property on which neither Trust nor Decedent have previously paid income tax which is a disposition for § 691(a)(2) purposes."

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

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

In PLR 2006-08032, 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.

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

6.5.09 ***The 3.8% additional tax on net investment income (NIIT)***

§ 1411, effective for 2013 and later years, imposes a 3.8% additional income tax on certain net investment income. This tax is nicknamed the "net investment income tax" (NIIT). The tax applies to individuals and, in a slightly different way, also to trusts and estates. See Regs. § 1.1411-0–§ 1.1411-10.

The tax applies to "net investment income" of individuals whose modified adjusted gross income exceeds a certain "threshold amount." "Modified adjusted gross income" (MAGI) means AGI increased by certain foreign items. § 1411(d). The "threshold amount" is MAGI of $250,000 for "A taxpayer making a joint return…or a surviving spouse…," half that amount for a married taxpayer filing separately, and $200,000 for other individuals. § 1411(b).

Investment income includes "interest, dividends, annuities, royalties, and rents" and "net gain" attributable to the disposition of property. § 1411(c)(1). Alimony and Social Security benefits are exempt from the NIIT. Reg. § 1.1411-1 (d)(4)(ii). Unlike the income threshold for taxing Social Security benefits, the threshold for this tax does not include municipal bond interest. Compare § 86(b)(2)(B).

Distributions from IRAs, Roth IRAs, qualified plans, 403(a) and 403(b) arrangements and 457(b) plans are not subject to the NIIT. However, income-taxable distributions from such retirement plans are included in threshold amount, so the effect will be the same in many cases as if they were subject to the tax. (Nontaxable distributions from any type of retirement plan, including qualified distributions from Roth plans, do not count towards the threshold.)

Chris Example: Chris and his wife have MAGI of $200,000 in 2013, including $50,000 of interest and dividends, before taking any IRA distributions. At this point they are not subject to the NIIT, because their MAGI is below the $250,000 threshold. Then Chris takes $100,000 from his IRA (all pretax money). This increases their MAGI to $300,000, putting them above the threshold by $50,000. Their entire $50,000 of interest and dividends are now subject to the NIIT.

To turn gross investment income into "net" investment income subject to the NIIT, the taxpayer is allowed only "deductions allowed by this subtitle which are properly allocable to such gross income or net gain." § 1411. This does not allow use of, *e.g.*, the charitable deduction to offset the NIIT. See Reg. § 1.1411-4(f). The NIIT system applies in a slightly different way to trusts and estates; as we shall see, a *trust* can use the charitable deduction to reduce its NIIT.

An individual is subject to a 3.8% tax on the lesser of (1) his net investment income (NII) and (2) his adjusted gross income (AGI) in excess of the "threshold" amount. § 1411(a)(1). A trust (or estate; the same rules apply to both) is in a very different position. First, rather than a high "threshold" amount designed to exclude low-income taxpayers, a trust gets into NIIT territory if its income is high enough to put the trust in the highest "regular" income tax bracket. § 1411(a)(2). That level is about $12,500 under both the old tax system (§ 1(e)) and the new (§ 1(j)(2)(E)), although § 1411(a)(2) seems to reference the "old" tax table.

Second, the trust is not taxed on its "NII" as an individual is; rather it is taxed only on its *undistributed* NII. So for a trust the NIIT is 3.8% of *undistributed NII*, or 3.8% of its AGI in excess of the threshold, whichever is less. § 1411(a)(2). The addition of the NIIT means that trusts and estates will pay a 40.8 percent tax on net investment income beginning at about $12,500 of taxable income. In view of this, consider whether certain classes of income should be directed to certain beneficiaries. For example, in a trust that authorizes the trustee to accumulate retirement plan distributions, the trust could direct the trustee to distribute all "investment income" to the life beneficiary, to avoid having the NIIT imposed on the trust; this could make sense if it is expected the beneficiary will probably not have high enough income to incur the NIIT. Such an allocation of a specific class of income is respected for purposes of the fiduciary income tax if it has independent economic effect; see Regs. § 1.643(a)-5(b) and § 1.642(c)-3(b) (with respect to charitable beneficiaries) and Reg. § 1.652(b)-2(b) (other beneficiaries).

The beneficiary who receives a trust distribution that is deemed to include NII must include such NII in his or her NII for purposes of the NIIT. Reg. § 1.1411-3(e)(3)(ii).

If a trust makes a distribution to a beneficiary, how do we determine whether that distribution "carries out" NII? For example, if the trust receives $5 of NII (subject to the NIIT) and a $5 IRA distribution (exempt from the NIIT), and distributes only $5 to the beneficiary, how do we know which class of income that distribution came out of? The Code gives no clue about how to determine which distributions reduce and which do not reduce the trust's NII. How to get from "NII" to "undistributed NII" is therefore entirely up to the IRS to determine, apparently.

Just as we have had, before the birth of the NIIT, three different systems for taxing personal income, the IRS has long had, in its regulations, two separate systems for figuring out what type of income is "carried out" via distribution from a trust to the trust beneficiary: The "DNI" (distributable net income) system of § 651–§ 652, § 661–§ 662, tells us how taxable income is or is not carried out to individual beneficiaries, and there is a second "system" with different rules for determining whether taxable income is carried out to a charitable beneficiary via the charitable deduction under § 642(c).

Not surprisingly, the IRS decided to graft the NIIT onto the existing rules for DNI and the fiduciary charitable deduction rather than create a third system for NIIT. As the IRS said in its Preamble to the proposed regulations under § 1411, "Undistributed net investment income is a section 1411 term used solely for estates and trusts (and not individuals), and is not defined in section 1411. The proposed regulations conform the taxation of estates and trusts under section 1411 to the rules of part I of subchapter J to avoid double taxation of net investment income and the taxation of amounts distributed to charities." So, "In the case of a distribution of DNI under section 651 or section 661 that consists of both net investment income and excluded income, the distribution must be allocated between net investment income and excluded income in a manner similar to § 1.661(b)-1 as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income." Reg. § 1.1411-3(e)(3)(i).

The regulation gives an example of a trust that receives interest income, capital gain, and an IRA distribution. Reg. § 1.1411-3(e)(5), Example 1. The interest and IRA distribution comprise DNI but the capital gain (being allocated to principal for trust accounting purposes) does not enter into DNI. The interest income and the capital gain are included in NII, but the IRA distribution is not NII. A distribution to the income beneficiary carries out NII and NII-exempt income in the same proportions as the interest income and IRA distribution bear to the total DNI.