



Online CLE

Naming a Trust as a Beneficiary of a Retirement Plan

1 Oregon Practice and Procedure credit

From the Oregon State Bar CLE seminar *Basic Estate Planning for Oregon Taxable Estates*, presented on November 15, 2019

Chapter 6

Naming a Trust as the Beneficiary of a Retirement Plan

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I. Introduction

Obviously the subject of retirement plans and all of the rules and regulations associated with them is far too expansive a subject for these materials to cover. Frankly, the subject of distributions from retirement plans is too broad for this presentation. In an effort to narrow the scope of this presentation to focus on working with retirement benefits and special needs trusts, many topics have been brushed over or not mentioned at all. For example, the discussion of naming a spouse as a beneficiary of a retirement plan is only mentioned briefly. You can find a very detailed explanation of anything retirement plan related in Natalie Choate's excellent diatribe, *Life and Death Planning with Retirement Benefits*,¹ a tome that was heavily relied on by this author in the preparation of these materials.

II. Terminology

- A. RMD = required minimum distribution = MRD = minimum required distribution
- B. Owner = the individual who contributed to and funded the retirement plan.
- C. Beneficiary = the person/entity who receives the benefits of the plan after the owner dies
- D. Retirement Plan = a retirement account that is established and managed by an Owner's employer
- E. Retirement Account = a private retirement account that is established by the Owner outside the context of his employment.

III. Types of Retirement Plans

- A. Qualified Retirement Plans (IRC Section 401(a))
 - 1. Defined Benefit Plans
 - a. Employer promises to pay the employee a specific sum of money beginning at retirement for the employee's life. The payment is usually on a monthly basis and is based on a formula that takes into account the length of employment with the company.
 - b. Defined Benefit Plans are a rare find. Mostly regulated to teachers and government employees.

¹ Choate, Natalie, *Life and Death Planning for Retirement Benefits* (7th Edition, 2011).

2. Defined Contribution Plans

- a. Employer commits to making certain contributions to the plan. As distinguished from a defined benefit plan, the employer does not guarantee any level of retirement benefit to the employee. Rather, the amount of funds in the employee's account will depend on: (1) the amount of contributions from the employer; (2) if the plan contains a 401(k) feature, the amount of deferred contributions from the employee; and (3) the investment performance of the funds in the account.
- b. 401(k), Profit Sharing Plans and Employer Stock Ownership Plans (ESOPs) are examples of defined contribution plans.

3. 403(b) Plans

4. Individual Retirement Accounts (IRAs)

- a. Traditional IRA
- b. Roth IRA

IV. Required Minimum Distribution rules

- A. Purpose. Remember that retirement plans are tax-favored investment vehicles that allow the owner/beneficiary to invest the funds without paying current income taxes on the profits. The tax is deferred until the funds are withdrawn from the account. The value of this tax-deferral can be dramatic.

Example: Assume a \$500,000 retirement account over a 40 year period²:

<i>Action</i>	<i>Amount held by beneficiary at year 40</i>
<i>Immediate distribution from IRA, followed by investment of funds in taxable investment account</i>	\$2,867,061
<i>Deferred distribution over 5 year period followed by investment of funds in taxable investment account</i>	\$2,972,035
<i>Deferred distribution based on 42-yr old life expectancy</i>	\$4,161,003
<i>Deferred distribution based on 18-yr old life expectancy</i>	\$5,704,839

However, it was the intent of Congress to install the tax-favored investment opportunities to encourage saving for *retirement* and NOT for the transfer of wealth to succeeding generations. For this reason, Congress built-in a rigid set of rules, the minimum required distribution rules (“RMDs”) to ensure that funds will be distributed out of the account and subject to income tax, RATHER than remain in the tax-favored investment indefinitely. Despite the intention of the RMDs to force distributions out of the plan (and subject to income tax), the tax-deferred benefits of the plan can exist long past the death of the owner if the owner designates the “right” beneficiary.³

B. RMDs during Lifetime of Owner

1. Because this presentation is focused on the rules regarding the transfer of an account after an Owner’s death, only the broad highlights of the lifetime distribution rules follow.
2. Highlights
 - a. No distribution prior to age 59 ½ without 10% penalty⁴
 - (1) certain exceptions apply; see 26 USC §72(t)(2)

² 7% assumed rate of growth; 35% tax bracket

³ While many of the code sections and regulations cited in this outline appear to refer to qualified plan section rules, IRC section 408(a)(6) makes those rules applicable to IRAs.

⁴ 26 USC §72(t)

- b. Must begin taking annual distributions upon reaching age 70 $\frac{1}{2}$. Actually, the first distribution must be withdrawn by April 1st of the year following the year in which the Owners turns 70 $\frac{1}{2}$ (a.k.a. the “required beginning date” or “RBD”).⁵
- C. RMDs after Death of Owner will depend on whether the Owner died BEFORE or AFTER her required beginning date (RBD).
1. Death **before** Owner’s RBD
 - a. Designated Beneficiary—>If the beneficiary of the account qualifies as a “Designated Beneficiary,” the RMDs will be based upon the age of the Designated Beneficiary (see section below for more detailed discussion of Designated Beneficiary).⁶
 - b. NO Designated Beneficiary—>If there is no beneficiary for the account OR the named beneficiary does not qualify as a Designated Beneficiary, the RMDs are subject to the 5-year rule.⁷ That is, the funds in the account must all be withdrawn by the date that is the 5th anniversary of the Owner’s death.⁸
 2. Death **after** the Owner’s RBD
 - a. Designated Beneficiary—> same as above. If the beneficiary of the account qualifies as a Designated Beneficiary, the RMDs will be based upon the age of the Designated Beneficiary (see section below for more detailed discussion of Designated Beneficiary).⁹
 - b. NO Designated Beneficiary—> If there is no beneficiary for the account or the beneficiary does not qualify as a Designated Beneficiary, the RMDs are calculated based on the Owner’s remaining life expectancy. That is, the funds

⁵ Pursuant to the Tax Reform Act of 1986, April 1, of calendar year following 70 $\frac{1}{2}$.

⁶ IRS Publication 590-B.

⁷ Treas. Reg. § 1.401(a)(9)-3, A-2

⁸ The 5-year rule only requires that the funds be withdrawn by the 5th year anniversary, but does not require that the distribution take place in 5 equal installments. The beneficiary may wait until the 5th year to take any distributions (although all the funds must be withdrawn) or may stagger the distribution in any way that she wants.

⁹ 26 CFR 1.401(a)(9)-5, A-5(a)(1)

must be withdrawn over the Owner's single life expectancy as if he/she were alive.¹⁰

D. Designated Beneficiary

1. As discussed above, the tax-deferred benefits of retirement plans can continue past the lifetime of the Owner if a Designated Beneficiary is named on the account. In that case, the measuring life of the RMD will switch the life expectancy¹¹ of the Designated Beneficiary. This is what's known as "stretching out" the distribution term to cover two lives, instead of just the life of the Owner.
2. A Designated Beneficiary is either:
 - a. A living individual.¹²
 - b. A See-Through Trust.¹³
3. NO entity other than a See-Through Trust can be a Designated Beneficiary, including an estate or a "opaque" trust (i.e. a trust that does not qualify as a See-Through Trust).¹⁴
4. Whether or not a Designated Beneficiary exists is determined as of September 30th of the year following the year of the owner's

¹⁰ The RMD is based on the participant's life expectancy however the beneficiary is always permitted to withdraw MORE than the RMD.

¹¹ 26 CFR 1.401(a)(9)-5, A-5(c)

¹² Surviving Spouses have special Designated Beneficiary privileges. Unlike other Designated Beneficiaries who must start taking their re-calculated RMDs the year following the year of the Owner's death, surviving spouse DBs may choose to roll the funds in the plan to their own IRA and wait until their own RBD to start taking distributions from the plan... AND then name their own Designated Beneficiary and continue the tax deferral into a 3rd life span!

¹³ Technically speaking, only individuals can be Designated Beneficiaries. So, when I state that a See-Through Trust qualifies as a Designated Beneficiary, I really mean that the trust is ignored and one of the individual beneficiaries of the trust is the Designated Beneficiaries. However, I find it more helpful to understanding these rules to make the distinction between "living individuals" (i.e. those individuals named as the outright beneficiary of the retirement plan) and "see-through trusts" (i.e. those trusts in which RMDs are payable to the trust based on a beneficiaries life expectancy). 26 CFR 1.401(a)(9)-4, A-5

¹⁴ 26 CFR 1.401(a)(9)-4, A-3

death.¹⁵ Because of this delayed time frame, it is possible to employ post-death “fixes” to get to Designated Beneficiary status.

a. For example, assume that a retirement plan is payable in equal shares to owner’s daughter and his favorite charity. Because of the presence of the charity as a partial beneficiary, there is no Designated Beneficiary as of the owner’s death. The payout period would either be 5 years or the remaining life expectancy of the owner, depending on the age of the owner at death. The charity would not likely care about this result, but the daughter would miss an opportunity to stretch out the deferral of income taxes over her lifetime. To fix this situation, the charity could be paid out its share of the plan by September 30th following the year of death. Once paid, the charity is no longer a beneficiary of the retirement, leaving the daughter as the sole AND DESIGNATED beneficiary.¹⁶

5. Separate Account Rule. If a retirement plan is payable to multiple beneficiaries, each beneficiary may establish a separate account with his/her/its share of the plan. IF the separate account is established prior to December 31st following the year of death, the beneficiary of each account will be considered the sole beneficiary of that account. Thus, all of the rules of determining the payout period of the RMD will apply separately to that account.¹⁷

a. **Important Caveat!** The separate account rule does NOT change the calculation of the RMD *if the division into separate accounts occurs via a single funding trust*. In that case, the RMD will still be determined by applying the rules relating to trusts as beneficiaries.

b. **Example:** Professor Dumbledore leaves his IRA to his revocable living trust. At his death, the RLT will terminate and pay out to Harry Potter, Hermione Granger and Ron Weasley in equal shares. Here, even if Harry, Hermione and Ron each establish separate shares by the end of the year following Professor Dumbledore’s death, the RMDs for each separate account will be based on the age of the oldest of them as required by trust distribution rules (see below for

¹⁵ 26 CFR 1.401(a)(9)-4, A-4(a)

¹⁶ This problem could also be solved by the separate share rule described in Treasury Reg. §1.401(a)(9)-8, A-2(a)(2).

¹⁷ 26 CFR 1.401(a)(9)-8, A-2(a)(2).

more detailed discussion of RMDs relating to trusts)
RATHER than allowing each of them to calculate his/her
separate RMD based on their own life expectancy.

V. Naming a Trust as Beneficiary

- A. As described above, only See-Through Trusts qualify as Designated Beneficiaries. Any other trusts that do not meet the requirements of a See-Through Trust will trigger RMDs based either the 5-Year Rule¹⁸ or the Life-Expectancy Rule.¹⁹
- B. Remember that the advantage of Designated Beneficiary status is the ability to stretch out the required payout of the retirement plan over the age of an individual.
- C. To qualify as a See-through Trust, the following FIVE requirements must be satisfied²⁰:

REQUIREMENT #1: The trust must be valid under state law— *EASY to meet*

REQUIREMENT #2: The trust must be irrevocable – *EASY to meet*

REQUIREMENT #3: A copy of the trust agreement must be provided to the retirement plan provider no later than October 30th of the year following the year of the Owner's death. —*should be EASY to meet*

REQUIREMENT #4: All of the beneficiaries of the trust must be identifiable- *should be EASY to meet*

- a. Note that the beneficiaries do not have to be identified by name. Identifying them by class is fine. E.g. “All of my children” or “My nieces and nephews who survive me”. An example of a trust beneficiary who is not identifiable would be “to my daughter’s husband”.

REQUIREMENT #5: All of the beneficiaries must be individuals

- a. *EASY* to meet for Conduit Trusts (see below)
- b. *VERY TRICKY* to meet for Accumulation Trusts (see below)

¹⁸ If Owner's death occurred BEFORE the RBD.

¹⁹ If Owner's death occurred AFTER the RBD.

²⁰ 26 CFR 1.401(a)(9)-4, A-5(b)

- D. There are 2 types of See-Through Trusts
 - 1. Conduit Trusts—> use age of lifetime beneficiary to determine RMD
 - 2. Accumulation Trusts-> use age of oldest beneficiary to determine RMD

- E. Conduit Trusts
 - 1. Conduit Trusts specifically provide that any RMDs received by the trust from a retirement plan will be immediately distributed out to the lifetime beneficiary of the trust. In this way, the trust acts as a middle-man that receives the RMD and passes it right back out to the beneficiary. For this reason, the IRS is willing to “see through” the trust and assume that the primary beneficiary is the “true” recipient of the RMD.
 - 2. Conduit Trusts use the primary beneficiaries age to calculate the RMD, as if the primary beneficiary had been named directly as the beneficiary on the retirement account.
 - 3. It is NOT enough that the terms of the trust require that “all income” be paid out to the beneficiary. Without more of an explanation, this terminology would default to fiduciary accounting income and would not necessary capture all of the RMD’s funds.
 - 4. The advantages of using a Conduit Trust are:
 - a. If properly drafted, the analysis is easy and clear– the trust qualifies as a Designated Beneficiary and the RMDs are calculated using the life expectancy of the primary beneficiary.
 - b. It provides the benefits of naming an individual beneficiary with the protection of putting the access to the account in another’s control (the trustee’s). This is especially handy when a parent wants to ensure that the RMDs are taken over time and does not want to tempt the beneficiary into taking more than the RMD.
 - 5. Trusteed IRAs. There is much confusion regarding trusteed IRAs and how they operate. Essentially, a trusteed IRA is a corporate managed conduit trust. While trusteed IRAs allow the owners to customize distributions from the account that exceed the RMD, they still require that all RMDs be paid out of the account to (or for the benefit of) the beneficiary. Thus, like privately-drafted conduit

trusts, trustee IRA accounts will NOT protect the beneficiary's eligibility for needs based benefits.²¹

F. Accumulation Trusts

1. Key Feature: The age of the OLDEST trust beneficiary is used to calculate the RMDs that will be paid to the trust each year from the retirement plan.²²
2. An accumulation trust is a trust that **does not** require the trustee to distribute any RMDs that the trust receives from a retirement plan to the beneficiary. In other words, the RMDs can accumulate inside the trust to be subject to the trust's distribution rules.
3. Any testamentary trust in which all distributions are within the discretion of the trust will NEVER qualify as a Conduit Trust but MAY qualify as an Accumulation Trust if the 5 see-through trust requirements (outlined above in V. B) are met.
4. A testamentary trust for a child has the *potential* to be treated as an Accumulation Trust for purposes calculating the RMDs if carefully drafted to meet all 5 see-through trust requirements.²³
 - a. The trust must be valid under state law;
 - b. The trust must be irrevocable;
 - c. A copy of the trust agreement must be provided to the retirement plan provider no later than October 30th of the year following the year of the Owner's death;
 - d. All of the beneficiaries of the trust must be identifiable; and
 - e. All of the beneficiaries must be individuals.

²¹ Natalie Choate has a brief explanation of trustee IRAs in her book, see *fn* 1 at p. 407.

²² 26 CFR 1.401(a)(9)-5, A-7

²³ 26 CFR 1.401(a)(9)-4, A-3, A-5

5. Requirements #4 & #5 - All beneficiaries must be identifiable individuals.
 - a. Which Beneficiaries Count???
 - (1) All potential beneficiaries, including remainder beneficiaries count.
 - (2) *Mere Potential successor beneficiaries*²⁴ do not count.
 - b. Using Natalie Choate's "Chain" test²⁵
 - (1) Assume current beneficiary counts as first "link" in countable beneficiary chain.
 - (2) Analyze all future (i.e remainder) beneficiaries of the trust by counting all successive beneficiaries until you come to the beneficiary(ies) who will be entitled to receive the trust property immediate and outright upon the death of the prior beneficiaries. That "immediate and outright" beneficiary(ies) is the last "link" in the countable beneficiary chain.
 - (a) Powers of Appointment: If a beneficiary has a power of appointment, all of the potential appointees as well as those who take in default of the exercise of the power of appointment must be analyzed in the chain.²⁶
 - (b) Embedded successor trusts: If the terms of a trust allow for funds to be held in further trust for a remainder beneficiary, the secondary trust must pass all five requirements of See-Through Trust Status.
 - (3) Consider all of the links: These are the beneficiaries that count for test requirements #4 & #5.
 - (a) Are they all identifiable?

²⁴ Treas Reg. §1.401(a)(9)-5, A-7(c).

²⁵She actually refers to this test as the "outright-to-now-living-persons" or "O/R-2-NLP" but this author prefers the simpler, albeit less descriptive, terminology. See *fn 1* at pgs. 440-443.

²⁶ See *fn 1* at pgs. 445-447

- (b) Are they all individuals?
 - i) Yes—? You have Accumulation Trust. The RMD is based on the age of the oldest chain beneficiary.
 - ii) No?— The trust is NOT an Accumulation Trust. The RMD is either the 5-Year Rule (owner died prior to RBD) or the owner's remaining life expectancy (owner died after RBD).
- (4) Chain Test is applied ONCE at the death of the owner based on the identities of the beneficiaries who are surviving at that moment in time and the hypothetical death of each of them until you reach the end of the chain.

6. Example: SIRIUS BLACK

Sirius Black directed his IRA to a trust to benefit his nephew, Harry Potter. The terms of the trust directed the trustee to distribute income and principal to Harry for his health, education, and support while he was under the age of 60. At age 60, the trust would terminate and the trustee would distribute the remaining assets to Harry outright. If Harry died prior to age 60, the trustee would distribute the trust to Harry's descendants, per stirpes; provided, however, that if any descendant of Harry's was under the age of 25, that descendant's share would be held in further trust for the descendant until age 60. The contingent beneficiary of Harry's and the descendants' trust is Sirius' favorite charity, Hogwart's School of Magic. Sirius dies with \$500k remaining in his IRA.

- a. Note that at the time the attorney drafts the trust (and hopefully the beneficiary designation) there is no way to confirm that the trust will qualify as a See-Through Trust.
- b. The presence of the charity creates the *potential* to fail Trust Requirement #5 (all "countable" beneficiaries must be individuals).
- c. But the facts, as they exist at Sirius' death, may save the trust from failing.
- d. If Harry is older than 60—> DB status exists. The trust is ignored and Harry is deemed to be the direct beneficiary of the IRA. The RMD will be based on his life expectancy.

- e. If Harry is younger than 60 but has 1 child who is older than 25, the trust can qualify as a See-Through Trust because all of the “countable” beneficiaries are individuals. That is, under these facts, if Harry died, the trustee would distribute the remaining trust property to Harry’s child immediately and outright. Because of this, Harry’s child is the last link in the countable beneficiary chain and we can ignore the charity.
- f. If Harry is younger than 60 and either: 1) does not have any children; or 2) has a child younger than age 25, the charity would be a countable beneficiary because there is no individual entitled to an immediate and outright distribution (assuming all preceding beneficiaries died).

7. Example: Druella Black

Druella Black named her revocable living trust as the beneficiary of her IRA. Her RLT stated that at her death, the trust would be split into 2 equal shares. One share would be distributed to her daughter, Narcissa Malfoy, outright and free of trust. The other share would be held in a lifetime support trust for her other daughter, Bellatrix Lestrage. At Bellatrix’s death, the remainder of the trust would be distributed to her nephew, Draco Malfoy.

Druella Black died with \$600,000 in her IRA survived by her daughters, Narcissa Malfoy and Bellatrix Lestrage, and her grandson, Draco Malfoy.

- a. Assuming all of the See-Through Requirements are met (and they appear to be), then we must determine the age of the OLDEST beneficiary of the RLT.—> Narcissa
- b. It does not matter that the RLT will terminate. Similarly, the result will not change if the account was divided and separate inherited IRA accounts were established (for Narcissa and Bellatrix). Separate share/account treatment DOES NOT FIX the problem if the direct beneficiary is a single funding trust, like a RLT.

VI. Drafting a Trust as an Accumulation Trust

- A. **GOAL:** Draft trust so that the primary beneficiary (the child who will primarily benefit from the trust assets) is the OLDEST potential beneficiary so that the beneficiary experiencing disability’s age is used to calculate the RMD.
 - 1. Because we know that the primary beneficiary’s age must count in the chain test, the goal is for that age is to be the “oldest” age.

2. Drafting focus is on the payout of the trust assets after the death of the primary beneficiary.
3. What are the client's goals?
 - a. Charity?
 - (1) Charitable beneficiary will cause the trust to fail as Accumulation Trust. Consider alternative estate planning ideas (see below).
 - b. Siblings or other family members?
 - (1) Can they receive distributions outright?
 - (a) Yes? → easier to draft
 - (b) No? → must then analyze remainder trust to test for oldest beneficiary

B. Examples:

Ron and Hermione Weasley have two adult children. Their daughter, Rose (35 yrs), is married with 3 children and their son, Hugo (38 years), has special needs. Ron and Hermione want to split their estate equally between their children and direct Hugo's share to a lifetime trust. One of the largest assets of their estate is Ron's IRA account which is \$800,000.

1. If Ron and Hermione were OK with Hugo getting regular trust distributions, a Conduit Trust would be an easy option.
2. If Ron and Hermione wanted the retirement plan money to be distributed at the discretion of the trustee (with no automatic distributions), an Accumulation Trust using Hugo's age as the measuring age could be drafted if: The remainder beneficiary of the trust is Rose, or if Rose is not then living, to Rose's children, outright.
3. If the clients want to hold any grandchild's share in trust until they reach a certain age, the drafting becomes trickier and the potential for failure of See-Through Status increase.
 - a. Consider the following:

“At the death of Hugo, the trustee shall distribute the remaining trust property to our daughter, Rose. If Rose is not then living, the trustee shall distribute the remaining trust property to Rose's descendants, by right of representation; provided however, if any

descendant of Rose is under the age of 35, the trustee shall continue to hold that descendant's share in a separate trust for such descendant until age 35."

Assume that the terms of the separate descendant's trust direct the trustee to distribute income and principal for the descendant's health and education until age 35, and if the descendant should die prior to age 35, the trustee should distribute the remainder of the descendant's trust to such descendant's descendants, by right of representation.

- (1) If, at the death of the survivor of Ron & Hermione, both Hugo and Rose are alive→ see through trust using Hugo's age as the measuring RMD life expectancy.
- (2) But what if Rose has predeceased and all of her children are under the age of 35 and none of them have any children?
 - (a) You have to test the descendants' trust but there is no outright beneficiary alive... now what? What does the contingent beneficiary provision say? Heirs at law?
 - i) Explain risk to clients and move forward?
 - ii) Switch to outright distribution to Rose's children?
 - iii) Switch remainder beneficiary of descendant's trust to siblings, outright?
4. The beneficiary designation form is critical here. It must direct Hugo's share of the account directly to his trust; not to Ron & Hermione's "estate" or to their revocable trusts.
5. Assume the same basic facts re: Ron and Hermione, except that they want Hugo's share to be distributed to their favorite charity.
 - a. See-Through Trust status is not an option.
 - b. Alternative planning ideas - see below.

C. Other Drafting Provisions

1. Include Definitions:

- a. Retirement Benefit means "an interest in one of the following types of assets if payable to this trust as a beneficiary or owned by this trust: a qualified or nonqualified annuity; a benefit under a qualified or nonqualified plan of deferred compensation; any account in or benefit payable under any pension, profit-sharing, stock bonus, or other qualified retirement plan; any individual retirement account or trust; and any and all benefits under any plan or arrangement this established under §408, §408A, §457, §403, §401, or similar provisions of the Internal Revenue Code.
- b. Retirement Account means "an account established or held at a financial institution that holds Retirement Benefits"

2. Material Purpose Clause.

- a. Why? Remember that Accumulation Trusts are simply drafted to qualify as a See-Through Trust under the rules and regulations pertaining to distributions from retirement accounts. The phrase "Accumulation Trust" or "See-Through Trust" are really just terms of art used by practitioners and those works do not generally appear anywhere in the provisions of the trust itself. So why not consider adding a separate provision in the SNT that clear

Example: "One of the material purposes of this trust is to allow it to qualify as a designated beneficiary of my retirement plan so that the life expectancy of my child, X, is used to calculate the minimum required distribution from the retirement plan under Treas. Reg. Section 1.401(a)(9)-9"

3. Explicitly state that the trust is Irrevocable.

- a. Why? The irrevocability of a testamentary trust is assumed because the grantor/settlor of the trust has died, but it probably doesn't hurt to simply state that the trust is irrevocable and make satisfying See-Through Trust Requirement #1 that much more obviously satisfied.

4. Prohibit the Use of Retirement Benefits to Pay Taxes/Debts/Expenses of Owner's Estate
 - a. Why? Most trusts (or state law) permit/require the trust to contribute \$ toward the payment of the decedent's taxes, debts and expenses. However, if the "estate" is deemed to be a potential beneficiary of the trust, this could cause the trust to flunk See-Through Trust Requirement #5 (all trust beneficiaries must be individuals).

Example: "The trustee may not, on or after September 30 of the year following the year of my death, use or apply any retirement benefit payable under any qualified retirement plan, individual retirement account or other retirement arrangement subject to the "minimum distribution rules" of Section 401(a)(9) of the Internal Revenue Code of 1986, as amended, for payment of my debts, taxes, expenses of administration or other claims against my estate, or for payment of estate, inheritance or similar transfer taxes due on account of my death. It being my intent that all such retirement benefits be distributed to or held only for individual beneficiaries. This section shall not apply to any distribution which is specifically directed to be funded with retirement benefits by other provisions of this Agreement".²⁷

5. Exclude Older Adopted People
 - a. Why? If your document or your state law treats an adopted person as a legal "descendant", in theory, there is the potential that a beneficiary of the trust could adopt someone older than the oldest identifiable beneficiary of the trust. Thus, violating See-Through Trust Requirement #4 (all trust beneficiaries must be identifiable).

Example: "A beneficiary's descendants shall not include any individual who is adopted after my death and is older than the oldest individual who is a beneficiary of this trust at my death."²⁸

6. Limit Powers of Appointment
 - a. Why? Under most state laws, the power to appoint allows the powerholder to appoint *in further trust* among the class of allowable appointees. This presents a potential problem

²⁷ See Choate, Appendix B, para 4.2 at p. 592.

²⁸ See Choate, Appendix B, para 4.3 at p. 593.

since we know that all trusts must pass the 5 See-Through Trust Requirements. The fact that some future trust may come into existence but whose terms are not known at the time of the owner's death could not be tested.

Example: "Notwithstanding any provision to the contrary, no retirement benefits may be appointed, distributed, or transferred to any other trust unless (1) the beneficiaries of the secondary trust are treated as having been designated as the direct beneficiaries of such retirement benefit under Internal Revenue Code § 401(a)(9); and (2) the oldest beneficiary of such other trust was not born in a year earlier than the year of birth of the oldest beneficiary of this trust"²⁹

7. Stand-Alone Trusts. Because of all the quirky drafting provisions suggested above and the ease in which to satisfy See-Through Trust Requirement #3 (provide retirement plan provider with copy of trust by 10/30 of year following year of death), many practitioners opt to have the accumulation trust as a separate stand-alone trust. This is not, however, required.

VII. The Beneficiary Designation Form

- A. The beneficiary designation form ("BD Form") is an essential piece of the puzzle in See-Through Trust status. You spend hours of time (and the client's money) carefully crafting a trust that meets all of the requirements of federal/state public benefits rules AND See-Through Trust minimum distribution rules but if the beneficiary designation form is incorrect or sloppily drafted, all of the effort and money will have been wasted.
- B. The SNT MUST be a DIRECT beneficiary of the retirement plan.
 1. Do not use the short-cuts of "my estate" or the revocable living trust and assume that because the assets will flow through the Will or Trust to the child's trust, that the child's trust is the beneficiary of the retirement plan; it is not.
 - a. Naming the "estate" will fail any chance of having the child's trust deemed as a See-Through Trust. The child's trust will be required to withdraw the retirement funds out over the 5-Year Rule or the remaining life expectancy of the owner, depending on the age of the owner at death.

²⁹ See Choate, Appendix B, para. 44 at p. 593.

- b. Naming the governing trust (i.e. the revocable living trust) will force the See-Through Trust Requirements to apply to the RLT, not just the child's trust. If the RLT has non-individual beneficiaries (charities, or an argument that the settlor's estate is a beneficiary (see VI, C, para 4 above), the RLT could cause the child's trust to fail to qualify as an Accumulation Trust.

C. The "Box" Problem

1. One of the most common problems with the BD form is that the forms are standardized and force the owner to translate his beneficiary designation intentions to fit into the boxes on the form.
 - a. Some BD forms do not even anticipate that there could be a testamentary trust as a beneficiary. They require the boxes for Tax ID and date of trust to be completed and of course, this information is not yet available for a testamentary SNT.
 - b. Other forms are more user friendly and either contemplate the use of a testamentary trust and/or allow extra pages to be filed with the form. If this option is available, I recommend taking advantage of it.
 - c. Also, this is the time when an actively involved financial planner can be a great resource. I often work directly with the financial planners and explain the clients' desires to incorporate the child's trust as direct beneficiary. The financial planner will then complete the forms and let me review. Further, it has often been the case that the financial advisor can "push through" the form in a situation where the financial institution may otherwise reject because of the box problem.

D. Memorandum to Clients

1. The completion of the beneficiary designation forms is often left in the client's hands, either because the client does not want to pay for the attorney to fill out the forms or because it is not part of the attorney's practice to complete the forms, or perhaps the client is shuffling through financial institutions and the beneficiary designation form is a future project. Whatever the case, I would provide the clients with a memorandum explaining the potential tax consequences of naming the child's trust as a beneficiary and the importance of the BD Form.

VIII. Alternative Estate Planning Ideas

A. Allocate Non-Retirement Assets to Child's Trust

1. Sometimes the facts of the client's situation does not fit into See-Through Trust status. In those cases, I sometimes play with allocating specific assets to the child's trust and other beneficiaries rather than simply dividing each asset proportionally between the beneficiaries.

Example: Petunia Dursley has a house worth \$350,000; a bank account worth \$150,000 and an IRA worth \$500,000. She has 2 children, an older son, Harry Potter (25 years), whom she adopted several years ago, and her younger son, Dudley (20 years), who lives with her and is not good with money management. For this reason, Petunia wants to hold Dudley's share of her estate in trust for his lifetime. She is also not interested in using conduit trust provisions. Petunia directs the house and bank account to the trust for Dudley and the IRA to Harry.

2. This can be slippery slope if client is truly striving for equality between the children though. Consider the example with Petunia above. While it appears that each child is receiving 50% of the value of Petunia's estate, realistically it is very unlikely that each child will receive an equal share.
 - a. Because of the inherent income taxes built in, the IRA is worth substantially less than \$500,000 to Harry.
 - b. Unless Petunia dies tomorrow, all of the values of these assets will fluctuate. Petunia may be subject to withdrawing her RMD from the IRA and as she does, she adds it to her bank account, thereby pulling value from Harry and giving it to Dudley.
3. One solution to this problem is the philosophical client. The client who gives up on trying to control the details of the outcome and decides "close enough" and whose kids hopefully share the same view.
4. Another solution is trying to regain equality via an equalization clause in the Will/Trust.

Example: Using the facts of Petunia above, assume that Petunia's assets are now:

house:	\$350,000
bank accounts:	\$150,000
investment account:	\$100,000
IRA	\$500,000

Petunia would prefer to avoid naming Dudley’s trust as the beneficiary of the IRA because Petunia’s preferred contingent beneficiary is her church. To the extent possible, Petunia wants to ensure that her children share equally in her estate. Petunia’s Will³⁰ could contain an equalization gift to Harry:

“If I am survived by both my children, It is my desire that each of my children share substantially equally in the distribution of my overall estate, including probate and non-probate assets. I intend to direct my non-probate assets to my son, Harry. To the extent that the value of those non-probate assets does not equal 50% of my net overall estate (after taxes and administration expenses have been paid), I hereby give a pecuniary amount of my probate assets to my son, Harry, so that he receives as close to an equal share of my overall estate as is possible under the circumstances.”³¹

- a. It’s important to note that this equalization gift only works if the value of the probate/RLT assets exceed the value of the non-probate assets.
 - b. If the value of the retirement benefits exceeded the value of the probate/RLT assets, the equalization gift would need to come from the retirement funds. Retirement funds cannot be controlled by a clause in the Will/Trust, the equalization direction would need to be incorporated into the beneficiary designation form. This author believes that such custom drafting of the form would be universally rejected by the financial institutions.
- (1) If equalization in these circumstances were still the goal, Petunia would need to:
- (a) Get comfortable with Dudley’s trust being a beneficiary of the IRA (and the resulting potential of either using Harry’s age, or if still incorporating church, the 5-year or Life Expectancy Payout)
 - (b) Periodically (and often) review her beneficiary designation form allocation with her financial planner to adjust Dudley’s trust share up/down.

³⁰ This would work just as well in a revocable living trust except that you would substitute the term “probate assets” with “trust assets”.

³¹ I would also recommend defining the terms “overall estate”; “probate assets” and “non-probate assets”.

IX. Take-Aways

- A. There are two types of “See-Through” Trusts that can qualify as the Designated Beneficiary of a retirement plan and “stretch” out the withdrawal of the retirement funds (and resulting income taxes) over the trust beneficiary’s lifetime.
- B. Conduit See-Through Trusts contain provisions that require all funds withdrawn from a retirement plan to be immediately distributed to the primary trust beneficiary. The primary beneficiary age is used to calculate the payout of the required minimum distribution.
- C. See-Through Accumulation Trusts use the age of the *oldest* beneficiary to calculate the payout of the required minimum distributions.
- D. See-Through Accumulation Trusts require careful drafting and a focus on remainder beneficiaries.
- E. The beneficiary designation form must show the trust as the direct beneficiary.
- F. Client’s estate planning goals may make Conduit and/or Accumulation See-Through Trust status impossible. Consider whether allocation non-retirement assets to the trust is possible.

Naming a trust as the beneficiary of a retirement plan



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Introduction

- This area is expansive!
- Topics not covered can be explained in
Natalie Choate's *Life and Death
Planning with Retirement Benefits*



Terminology

- **RMD** = required minimum distribution
 - Aka MRD = minimum required distribution
- **Owner** = the person who funded the plan/account, or on whose behalf the employer funded the plan
- **Beneficiary** = the person/trust who inherits the plan/account after the death of the owner
- **Retirement Plan** = a retirement account that is established and managed by an Owner's employer
- **Retirement Account** = a private retirement account that is established by the Owner outside the context of employment

Introduction

- What we will cover:
 - A general primer on minimum distribution rules
 - Naming a trust as a beneficiary of a retirement plan
 - Conduit Trusts
 - Accumulation Trusts
 - Managing Client Intentions
 - Drafting Considerations
 - Beneficiary Designation Forms
 - Alternative estate planning ideas
 - Payback Trusts
 - Post-Death Fixes

Introduction

- Why a Trust?
 - Child has special needs
 - Child is a minor
 - Child is a spendthrift
- Examples in this presentation are a spin on this common theme

Required Minimum Distributions

Required Minimum Distributions

Purpose:

- Retirement plans are tax-favored investment vehicles that allow the owner/beneficiary to invest funds without paying current income taxes on the profits
- The tax is deferred until the funds are withdrawn
- This deferral can be a HUGE financial benefit!

Required Minimum Distributions

\$500,000 retirement plan over a 40 year period

Action	Amount held by beneficiary after 40 years
Immediate distribution followed by investment	\$2,867,061
Deferred distribution over 5 years followed by withdrawal and then investment	\$2,972,035
Deferred distribution based on 42 yr-old life expectancy	\$4,161,003
Deferred distribution based on 18 yr-old life expectancy	\$5,704,839

Required Minimum Distributions

BUT...

- Congress' intent is to encourage savings for retirement NOT to foster income tax-free transfers of wealth through the generations
- So... we have the Required Minimum Distribution Rules

Required Minimum Distributions

RMD after the death of the Owner will depend on whether the Owner died **before** or **after** her RBD.

– **Before:**

- If designated beneficiary (“DB”) → Age of DB
- If no DB → 5-year Rule
 - Funds must be withdrawn by 5th anniversary of death

– **After**

- If DB → Age of DB
 - If no DB → Owner's remaining life expectancy
- Can always withdraw more!

Required Minimum Distributions

Designated Beneficiary Advantage

- Tax-deferred benefits can continue past the lifetime of the Owner if a Designated Beneficiary is named on the account.
- The “measuring life” of the RMD will switch to the life expectancy of the Designated Beneficiary; thus “stretching out” the distribution term to cover two lives.

Required Minimum Distributions

Who is a Designated Beneficiary?

– A Living Individual

- Surviving spouses have special DB privileges.
 - Roll-over to spouse’s own IRA and
 - Name their own DB to continue tax deferral into a 3rd lifespan

– Certain See-Through Trusts

- No other entity (including an estate or a “opaque” trust) can be a DB

Multiple beneficiaries analyzed as a group

- All must be designated beneficiaries
- Age of oldest calculates the RMD

Post-Death Fixes

- Designated Beneficiary status tested as of September 30th of the year following the owner's death— “the September 30th Rule”
- Time frame provides opportunities for post-death “fixes” to achieve DB status
- Eliminate undesirable beneficiary
 - Pay beneficiary out by September 30th
 - Cooperative beneficiary disclaims interest

Example:

Severus Snape dies on October 1st when he is 75 years old. Harry Potter and Hogwarts School of Magic are named as the equal beneficiaries of his IRA.



Post-Death Fixes

- Because a charity is one of the beneficiaries – there is no DB as of Snape’s death
- If nothing changes, the RMD based on Snape’s life expectancy.
- Charity wouldn’t care but Harry would miss opportunity to stretch payout over his life
- If Hogwarts was paid out in full by September 30th, they would no longer be considered a beneficiary
- Harry would be sole beneficiary and get DB payout

Post-Death Fixes

Separate Accounts Rule

- If retirement account is payable to multiple beneficiaries, each beneficiary may set up separate account with his/her share
- If separate account is established by December 31st following the year of owner’s death, beneficiary can use his/her age to determine RMD of the account
- Not tied to oldest beneficiary of group
- Does NOT apply to trust beneficiaries when Trust named

Post-Death Fixes



Example: Albus Dumbledore dies at age 105 on November 15th of 2016. He leaves his \$3million IRA as follows: 50% to Hogwarts; 25% to Harry Potter and 25% to Rubeus Hagrid.

Photo credit: fanpop.com

Post-Death Fixes

- No further actions → Group analyzed together
 - No DB (because of Charity)
 - Life expectancy rule applies

- Payout Hogwarts by September 30, 2017
 - DB status
 - Hagrid's age used to calculate RMDs for both Harry and Hagrid

Post-Death Fixes

Payout Hogwarts and Harry establishes separate account by December 31st

- DB status
- Harry can use his own age to calculate RMD for his account

**If Dumbledore named his revocable trust (which in turn named Hogwarts, Harry and Hagrid as its beneficiaries); post-death fixes can't apply

Designated Beneficiary Trusts

Designated Beneficiary Trusts

5 requirements for a Designated Beneficiary Trust:

1. Trust must be valid under state law
2. Trust must be irrevocable
3. A copy of the trust agreement must be provided to the retirement plan provider no later than October 30th of the year following Owners death
4. Beneficiaries of the trust must be identifiable (by class is fine)
5. All beneficiaries must be individuals

Designated Beneficiary Trusts

Two types of Designated Beneficiary Trusts:

1. **Conduit Trusts** → Use age of lifetime beneficiary to determine RMD
2. **Accumulation Trusts** → Use age of *oldest beneficiary* to determine RMD

Designated Beneficiary Trusts

Conduit Trust

- Trust must be drafted to require any withdrawals from retirement plan/account to be immediately distributed to the lifetime beneficiary
 - “all income” is not enough
- IRS assumes that the “true” recipient of the RMD is the primary beneficiary
- The primary beneficiary’s age is used to calculate the RMD

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Designated Beneficiary Trusts

Conduit Trust

ADVANTAGES

- A Conduit Trust always qualifies as a DB
- Tax advantage of naming an individual beneficiary with the protection of a trust
- Easy to draft

DISADVANTAGES:

- A Conduit Trust requires automatic distributions to the beneficiary
- Because of the automatic distribution, a Conduit will usually NOT work for a Special Needs Trust or a trust for a spendthrift beneficiary

Designated Beneficiary Trusts

Conduit Trust

Example: Xenophillius Lovegood wishes to leave his \$1million IRA to his only child, Luna, but he is concerned about Luna's financial maturity. While Xenophillius trusts his daughter with smaller sums of money, Luna would not appreciate the advantage of tax-deferred growth and would likely pull out all of the funds to start a fashion eyeglass design business.

Xenophillius would prefer to have a trustee manage the distribution of the IRA to Luna but wants to ensure that Luna's age is used to calculate the RMD on the account.

Designated Beneficiary Trusts

Conduit Trust



The terms of Luna's Trust require the trustee to withdraw the minimum required distribution from any applicable retirement account, plus any further sums that the trustee deems necessary and immediately distribute those funds to Luna.

Conduit Trust → Luna's age will be used to calculate the minimum required distribution from the account.

Photo credit: wizardsandwhatnot.com

Designated Beneficiary Trusts

Conduit Trust

Trusted IRAs

- Corporate-managed conduit trust
- Allows for customization of distributions that **exceed** the RMD
- Will not usually work for trusts where you don't want the beneficiary to have automatic distributions

Designated Beneficiary Trusts

Accumulation Trust

Accumulation Trusts:

- Trust is drafted to allow RMDs to accumulate in the trust
 - no automatic distribution like Conduit Trust
- Best choice for Clients who do not want regular and automatic distributions to the beneficiary
- The age of the ***oldest beneficiary*** is used to calculate the RMDs

Designated Beneficiary Trusts

Accumulation Trust

1st Requirement: The trust must be valid under state law → Easy

2nd Requirement: The trust must be irrevocable → Easy

3rd Requirement: A copy of the trust document must be submitted to retirement plan provider by 10/30 of year following year of death → Easy

Designated Beneficiary Trusts

Accumulation Trust

4th Requirement: All trust beneficiaries must be identifiable

- Must be able to identify both current & “countable” remainder beneficiaries to find “oldest”
- Identifying by class (“my nieces who survive me”) is fine

5th Requirement: All trust beneficiaries must be individuals

- Which Beneficiaries Count?

Designated Beneficiary Trusts

Accumulation Trust

Natalie Choate's Chain Test:

- Assume current beneficiary counts as first “link” in countable beneficiary chain
- Analyze all future (i.e., remainder) beneficiaries of the trust by counting all successive beneficiaries until you come to the beneficiary(ies) who will be entitled to receive the trust property immediately and outright upon the death of the prior beneficiaries.
- That “immediate and outright beneficiary(ies)” is the last beneficiary “link” in the countable chain

Designated Beneficiary Trusts

Accumulation Trust

Once you know your “links”, then test

- Are they identifiable?
- Are they individuals?
 - Yes?→ Accumulation Trust→ RMD is age of oldest “link” beneficiary
 - No?→ No Accumulation Trust→ No DB→ RMD based on 5-Year Rule or Life Expectancy Rule

Designated Beneficiary Trusts

Accumulation Trust

- Embedded/Successor trusts create more beneficiaries to test
- Powers of appointment → all of the potential appointees as well as those who take in default must be analyzed in the chain

Designated Beneficiary Trusts

Accumulation Trust

Example: Sirius Black directed his IRA to a trust to benefit his godson, Harry Potter:

- While Harry under 60, the trustee can distribute for HEMS (health, education, support & maintenance)
- If Harry dies prior to age 60, the trust would be distributed to Harry's descendants, per stirpes
- Any share for a descendant under age 25 would continue in another trust for that descendant until age 25
- The contingent beneficiary of Harry's and the descendant's trust is Hogwarts School of Magic

Designated Beneficiary Trusts

Accumulation Trust

Sirius dies with \$2million in his IRA...

- Note at the time the trust was drafted there is no way to confirm whether or not the trust would qualify as an Accumulation Trust
- The presence of the charity creates *potential* for failing Requirement #5
- The analysis depends on the facts as they exist on September 30th following the year of Sirius' death

Designated Beneficiary Trusts

Accumulation Trust

- If Harry is older than 60:
 - Designated Beneficiary Trust status is moot
 - Harry is deemed to be the direct beneficiary
 - DB status; RMD based on Harry's life expectancy

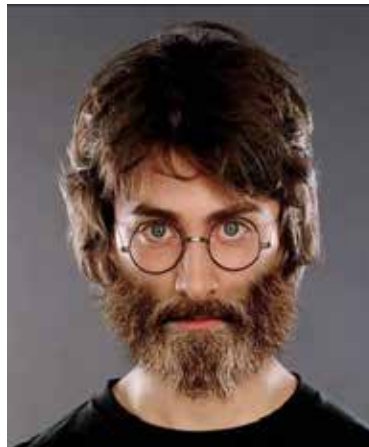


Photo credit: funnystack.com

Designated Beneficiary Trusts

Accumulation Trust



If Harry is younger than 60 and all of children are over the age of 25...

- The countable links are Harry and his children
- Harry's age will be used to determine the RMD

Photo credit: moviefone.com

Designated Beneficiary Trusts

Accumulation Trust



- If Harry is younger than 60 and...
- He does not have any children OR any child is under age 25...

- The countable links now include Hogwarts
- No Designated Beneficiary Trust (Requirement #5 fails)

Photo credit: harrypotter.wikia.com

Designated Beneficiary Trusts

Accumulation Trust

Druella Black named her revocable living trust as the beneficiary of her IRA. The relevant terms of Druella's RLT provide:

- At Druella's death, RLT splits into 2 shares
- One share distributed outright to Druella's surviving daughter, Narcissa
- Other share held in a trust for the benefit of Druella's other daughter, Bellatrix

Designated Beneficiary Trusts

Accumulation Trust

- At Bellatrix's death, the remainder of the trust would be distributed to her nephew, Draco Malfoy



Photo credit: playbuzz.com

Designated Beneficiary Trusts

Accumulation Trust

Analysis

- Both the RLT and Bellatrix’s trust must be tested

- Designated Beneficiary Trust Requirements
 - #1- valid under state law→ yes
 - #2- irrevocable-→yes
 - #3 trust doc provided to IRA provider→ assume yes
 - #4 trust beneficiaries are identifiable→ yes
 - #5 trust beneficiaries are individuals→ yes

- Oldest beneficiary of RLT is Narcissa

Designated Beneficiary Trusts

Accumulation Trust

- Even if Narcissa and the trustee of Bellatrix trust established separate accounts with their share of IRA
 - Narcissa is still measuring age

 - Separate Account Rule does not apply when direct beneficiary is RLT (or other funding trust)

- Different result if Druella had directly named Narcissa and Bellatrix’s trust as the 50/50 beneficiaries of the account – then separate account rule could have applied

Managing Client Intentions

Client Intentions

- Accumulation Trust
 - What are the client’s intentions after the primary beneficiary passes away?
 - Charity?
 - Charity will cause trust to fail as Accumulation Trust
 - Family & Friends?
 - Can they receive distribution outright?
 - Yes?→ easiest to draft; easy to check age of oldest
 - No?→ harder; must analyze potential remainder trusts

Client Intentions



Photo credit: galeria.potterish.com

Example:

Ron and Hermione Weasley have 2 adult children. Their daughter, Rose (35 yrs), is married with 3 children. Their son, Hugo (38 years), has special needs. Ron and Hermione want to divide their estate equally between their children and direct Hugo's share to a SNT. The largest asset of their estate is Ron's \$3million IRA account.

Client Intentions

- Because Hugo's Trust is a SNT, Ron and Hermione do NOT want regular and automatic distributions to Hugo
 - Only option is to analyze as an Accumulation Trust
 - Note no guarantees here— Accumulation Trust status tested upon "future" unknown facts
 - Will depend on client's wishes concerning remainder beneficiaries

Client Intentions

- Best Case Scenario for Accumulation Trust → outright individual remainder beneficiaries:
 - Rose is the remainder beneficiary of the SNT;
AND
 - If Rose is not then living, the grandchildren (GC) are the outright remainder beneficiaries

Client Intentions

- Assume Ron and Hermione want any share for a GC to be held in further trust until the GC reaches age 35; and if a GC dies prior to age 35, to the GC's descendant's per stirpes
 - Trickier drafting
 - Potential for failing Accumulation Trust status increases

Client Intentions

- If Hugo and Rose survive the Clients
 - See Through Trust→DB→ oldest beneficiary (Hugo)

- If Hugo survives but Rose has predeceased leaving children
 - All over 35? Same result as above
 - Any child under age 35?
 - Must test GC trust but no identifiable outright beneficiary of GC trust if GC died prior to age 35.
 - Now What?→ check contingent beneficiary provision

Client Intentions

Ron & Hermione must prioritize...

- Tax Savings?→
 - switch to outright distribution to Rose's children
 - Or...draft remainder beneficiary of GC's trust to be to GC's siblings, outright

- Control of \$ over young descendants
 - Explain risk and move forward

Client Intentions

- Assume Ron and Hermione want to direct remainder of Hugo's SNT Trust to charity
 - Accumulation Trust is not option for Hugo's SNT
 - 5-Year Rule or Life Expectancy Rule
 - Move forward anyway?

Beneficiary Designation Forms

Beneficiary Designation Forms

- The “BD” form is critical to BD Trust status
- Must name the intended trust directly
 - “50% to the trustee of the SNT created for my son Hugo under my revocable trust dated xx”

Beneficiary Designation Forms

- Do NOT name the “Will” or “Estate” with understanding that \$ will flow from there to the intended trust
 - No DB status available
 - Five-Year Rule or Life Expectancy Rule will apply
- If you name the revocable trust:
 - The RLT must pass Beneficiary Designated Trust requirements
 - Any non-individual (even as contingent) will cause problems

Beneficiary Designation Forms

- The “Box” problem
 - Standardized forms do not allow for custom drafting
 - Some forms do not even allow for testamentary trust to be considered as beneficiary
 - Some forms are more user-friendly and allow for extra language to be “attached”
 - A good financial planner can be the “hammer” to push through custom drafted form

Alternative Estate Planning Ideas

Alternative Estate Planning Ideas

Idea #1

Allocate Retirement Funds to non-trust beneficiary and other estate assets to trust

Alternative Estate Planning Ideas

Allocate Non-Retirement Assets to Trust



Photo credit: harrypotter.wikia.com

Example:

Petunia Dursley has a house worth \$750k; a bank account worth \$250k and an IRA worth \$1million. She has 2 children: a younger son, Harry (who she adopted several years ago) and an older son, Dudley. Dudley lives with her and is not good at managing money.

Petunia's Will directs her estate to a lifetime trust for Dudley.

Petunia names Harry as the 100% beneficiary of her IRA.

Alternative Estate Planning Ideas

Allocate Non-Retirement Assets to Trust

- Not truly equal
 - IRA is worth substantially less than \$1million to Harry because of the income taxes
 - Values will continue to fluctuate
 - As Petunia pulls out her RMDs, she'll add them to bank account, thereby reducing Harry's share and adding to Dudley's share
- Solutions
 - Philosophical Client- "that's life"
 - Another solution may be including an Equalization Clause

Alternative Estate Planning Ideas

Idea #2

Utilize an Equalization Clause

Alternative Estate Planning Ideas

Equalization Clause

- Similar facts as above, except Petunia has:

House: \$750k
Bank account: \$250k
stock account: \$300k
IRA: \$1million

- Petunia's goals:
 - Avoid naming Dudley's trust as beneficiary of her IRA because she wants to name her Church as the remainder beneficiary of the trust
 - Ensure that her children receive equal shares of her estate

Alternative Estate Planning Ideas

Equalization Clause

- Petunia names Harry as the 100% beneficiary of her IRA
- In her Will, Petunia gives Harry a specific pecuniary gift to equalize his share of her overall estate
- Petunia's Will directs the residue of her Estate to Dudley's trust

Alternative Estate Planning Ideas

Equalization Clause

“If I am survived by both of my children, it is my desire that each of children share equally in the distribution of my overall estate, including both my probate and non-probate assets. I intend to direct my non-probate assets to my son, Harry. To the extent that the overall value of those non-probate assets does not equal 50% of my net overall estate (after the payment of taxes and administration expenses), I hereby give a pecuniary amount of my probate assets to my son, Harry, so that he receives as close to an equal share of my overall estate as is possible under the circumstances”

Alternative Estate Planning Ideas

Equalization Clause

House:	\$750k
Bank account:	\$250k
stock account:	\$300k
IRA:	\$1million

Petunia’s overall estate = \$2,300,000

Harry would receive:

\$1,000,000 IRA
\$150,000 under the Will

Dudley’s Trust would receive:

\$1,150,000 under the Will

Alternative Estate Planning Ideas

Equalization Clause

- Equalization gift only works when value of probate/RLT assets **exceed** value of retirement assets
- If retirement account value is higher, than equalization amount would need to come from IRA
 - How to incorporate equalization clause in BD form?
 - Petunia would have to name Dudley’s trust as beneficiary of “excess” portion of IRA
 - Get comfortable with 5-year/Life Expectancy rule applying
 - Periodically and often review her IRA account value and adjust BD form accordingly

Alternative Estate Planning Ideas

Idea #3

Consider Multiple Trusts

Alternative Estate Planning Ideas

Multiple Trusts

- Similar facts as above, except Petunia has:

House:	\$750k
Bank account:	\$250k
IRA:	<u>\$1,200,000</u>
total:	\$2,200,000
- Petunia's goals:
 - Giving money from Dudley's trust to her Church upon Dudley's death
 - Ensure that her children receive equal shares of her estate

Alternative Estate Planning Ideas

Multiple Trusts

- In order to equalize the estate, \$100k of retirement funds must be directed to Dudley trust
- **Trust#1** is the beneficiary of \$100k of the Retirement Plan
 - Drafted so that the remainder beneficiaries are Harry's children, outright.
 - If none of Harry's children are then living, then to closest living heir's who are younger than Dudley
- **Trust #2** is the beneficiary of the non-retirement assets
 - Remainder beneficiary is Petunia's Church

Alternative Estate Planning Ideas

Idea # 4

Rethink Using IRA Funds for Disclaimer

Alternative Estate Planning Ideas

Disclaimer

Recall the example with Ron/Hermione. The largest asset of the estate was Ron's IRA. Should the primary beneficiary section of the IRA beneficiary designation form be prepared to allow Hermione to disclaim the IRA funds into a disclaimer trust to keep them out of her estate?

- disclaimer trust has conduit language
 - IRA distributions taxed to Hermione, not trust
 - Hermione age locked in to determine RMD

Alternative Estate Planning Ideas

Disclaimer

- But if Hermione lives until her life expectancy, all the disclaimed IRA funds come out to via conduit and are taxable in her estate (as if she never disclaimed them)
- If Hermione doesn't live to her life expectancy, kids will have to continue to use her age for *their distributions* (no reset of RMD at H's death)
- If Hermione didn't disclaim and did a spousal rollover, her RMD would be calculated by using a joint life expectancy of H and someone 10 years younger— the funds last beyond her single life expectancy

Post-Death Fixes

Post-Death Fixes

- **September 30th Rule** → Payout “undesirable” beneficiary by September 30th of year following year of owner’s death
- **Separate Account Rule** → each beneficiary named on BD form creates separate account for allocated portion of IRA
 - Each separate account is tested separately to determine RMD
 - Not tied to other beneficiaries

Post-death Fixes – Reform BD Form

PLR 200616039

- Dad rolled IRA to new company and directed company to follow bene designations with previous company
- Previous BD form had named daughters as contingent benes
- Company did not follow directions
- Wife predeceased
- Daughters had probate court reform the BD Form
- IRS approved the reformation; used life expectancy of oldest daughter

Post-death Fixes – Reform BD Form

PLR 200742026

- H named W on BD Form but did not name contingent benes
- W predeceased
- Custodial agreement provided default bene was the “estate”
- Daughter had probate court reform the BD form to include herself as contingent
- IRS ignored reformation
- RMDs calculated on H’s remaining life expectancy

Post-death Fixes – Reform BD Form

PLR 200846028

- Owner died before RBD
- BD Form stated “As provided in Will”
- Owner had RLT which distributed to 8 people
- RLT trustee obtained court order stating that the BD form should be interpreted as naming 8 people directly
- IRS did not agree → 5 Year Rule applied

Post-death Fixes – Reform Trust

- Retirement account directed to trust that does not qualify as a Accumulation Trust
- Modify Trust?

Post-death Fixes – Reform Trust

PLR 201021038

- Owner died after RBD
- BD Form named lifetime trusts for 2 children
- Trust gave child a power of appointment that included charity
- Trustee had court modify the Trust as follows:
 1. Insert Conduit language
 2. Eliminate the possibility of appointing to charity
 3. Inserted the “protection” clauses
 1. Prohibit \$ from being used for estate expenses
 2. No older adoptees

Drafting Considerations

Drafting Considerations

Conduit Trust

- Language requiring trustee to immediately distribute retirement plan withdrawals to the beneficiary

Example:

DISTRIBUTION OF RETIREMENT BENEFITS. Each year, the trustee shall withdraw from any Retirement Benefit, the Minimum Required Distribution for such Retirement Benefit for such year, plus such additional amount(s) that the trustee deems advisable in his or her sole discretion. All amounts so withdrawn (net of expenses) shall be immediately distributed to or for the benefit of [Child]

Drafting Considerations

Accumulation Trust

- No magic language like conduit
- Drafting focus is on the payout of the trust assets after the death of the primary beneficiary.
- Analyze using “chain test”

Drafting Considerations

Material Purpose Clause

- Why?
- Terms “See-Through Trust” or “Accumulation Trust” are terms of art;
- Clarifies any confusion about why you drafted remainder beneficiaries differently than expected

“One of the material purposes of this trust is to allow it to qualify as a designated beneficiary of my retirement plan so that the life expectancy of my child, ____, is used to calculate the minimum required distribution under Treas. Reg. 1.401(a)(9)-9”

Drafting Considerations

Prohibit use of retirement funds to pay taxes/debts/expenses

- Most state laws allow allocation of debts and taxes among the beneficiaries, including trusts
- If retirement funds are paid to the trust and then used to pay taxes/debts/expenses of the decedent’s estate, the “estate” could be deemed to be a beneficiary of the retirement account
- Flunk Trust Requirement #5

Drafting Considerations

Limit Powers of Appointment

- Why?
- Most state laws allow POAs to be exercised to appoint “in further trust”
- All trusts must be tested, but this is a future potential trust that cannot be tested because terms are not yet known

Drafting Considerations

Exclude older adoptees

- Why?
- If document or state law treats adoptees as legal “descendants” and someone’s descendants are the potential beneficiaries of the trust, the oldest potential beneficiary is now unidentifiable
 - Potential for someone older than ‘oldest’ beneficiary to be adopted later
 - Flunks Trust Requirement #4

Drafting Considerations

Stand- Alone Trust

- Not required
- Preferred by some attorneys because:
 - Quirky drafting provisions that you don’t want applied to other trusts
 - Ease to satisfy Trust Requirement #3

Take-aways

- Two types of Designated Beneficiary Trusts

- 1. **Conduit Trusts**

- Conduit Trusts contain terminology that require all funds withdrawn from the retirement account to be immediately distributed to the beneficiary
 - Conduit Trusts use the age of the primary trust beneficiary to calculate the RMD that must be withdrawn each year

Take-aways

- 2. **Accumulation Trusts**

- Accumulation Trusts require careful drafting and focus on remainder beneficiaries
 - Accumulation Trusts are generally the only option for SNT
 - Client’s estate planning intentions may make Accumulation Trust impossible

Take-aways

- What are the Client's Priorities
 - Tax Savings?
 - Control?
- Need to include savings clauses
- Pay particular attention to BD Form

Take-aways

- Consider alternative strategies
 - Allocate non-retirement to trust
 - Equalization Clause
 - Multiple trusts

Take-aways

- Consider post-death Fix
 - September 30th Rule
 - Separate Accounts Rule
- Don't Assume that Court Orders to modify/reform will work

The Secure Act

- “Settling Every Community Up for Retirement Enhancement” Act
- Passed the House easily but languishing in the Senate
- Big Changes
 - Allows small business to band together to offer and maintain 401(k) plan for employees
 - Raise the mandatory distribution age to 72
 - Requires mandatory payout of inherited accounts within 10 years!