Retirement Benefits and Lifetime Trusts

by
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The intersection of estate planning and retirement benefits[1] can be a daunting place to practice law, particularly when the client wants to direct his/her retirement assets to a lifetime trust for the benefit of a child or other family member. When these situations arise, it is important for attorneys to understand how the minimum distribution rules under Internal Revenue Code §401(a)(9) and the corresponding Treasury Regulations will apply. The purpose of this article is to highlight and explain some general issues that attorneys should understand when they wade into these murky waters. I've purposely written this article with an informal tone and colloquial language in the hopes of translating technical rules into understandable concepts. Where I thought necessary, I've footnoted the more formal explanation and/or appropriate cite.

Retirement accounts are tax-favored investments because the income earned each year is not subject to income taxes until the funds are withdrawn from the account, thus allowing the owner to invest the funds that would have been paid for income taxes. This tax deferred growth will generally yield a significantly larger future value than an investment that is subject (and reduced by) income taxes from year to year. The longer that funds can remain in the account, the more significant the impact of this tax-deferred growth. This is why many savvy retirement account owners will wait until they reach age of 70 ½, also known as "the required beginning date"- the date that the IRS requires the owners to begin to withdraw funds out of the retirement account and pay the resulting income taxes.[2]

Many clients are surprised to learn that the minimum distribution rules that apply to an *owner* of a retirement account do not apply to the *inheritor* (i.e. *"beneficiary")* of a retirement account. Rather than being allowed to wait until age 70 ½ [3] to start

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[1] The rules discussed in this article apply to many different types of retirement benefits, including IRAs, Roth IRAs, SEPs, 401(k) plans and 403(b) plans but for convenience I will use the term "retirement account" throughout this article which shall generally include all of these different types of retirement benefits.

[2] Technically, the required beginning date is April 1st of the year following the year that the owner turns age 70 ½. IRC §401(a)(9)(C). There is an exception for Roth IRAs here. The minimum distribution rules only apply to Roth IRAs after the owner's death so there is no required beginning date for the owner of a Roth IRA.

[3] See footnote #2.

withdrawing money from the account, the beneficiary of a retirement account must start taking distributions the year following the year of the owner's death, no matter the age of the beneficiary[4]. The amount that they are required to withdraw from the account (the "minimum required distribution" or "MRD") will depend on whether the beneficiary qualifies as a "Designated Beneficiary". Designated Beneficiaries use a person's age to calculate the MRD.[5] This is usually an advantage when the applicable age is younger than the owner because the MRDs are spread over the remaining life expectancy of the Designated Beneficiary, thus minimizing the amount of the MRD subject to income taxes and, perhaps more importantly, allowing the balance of the funds to remain in the account and soak up all of that good tax-deferred growth.[6]

Only an individual and certain types of trusts (what I'll refer to as "see-through trusts") qualify as a Designated Beneficiary. No other entity-an estate, charity or "opaque" trust will qualify.[7] If a beneficiary is not a Designated Beneficiary, or no beneficiary is named on the appropriate form with the financial company managing the retirement account, the distribution time period that the funds will need to be withdrawn/distributed from the retirement account will depend on whether the owner died before or after their required beginning date,[8] If the owner died before their required beginning date, the distribution period is 5 years from the owner's death. If the owner died after their required beginning date, the distribution period is the owner's remaining life expectancy.[9]

The focus of this article is naming a trust as the beneficiary of a retirement plan. So, what trusts qualify as a See-Through Trusts and therefore receive the Designated Beneficiary advantage described above? There are five requirements for a trust to qualify as a See-Through Trust: (1) The trust must be irrevocable; (2) the trust must be valid under state law; (3) a copy of the trust instrument must be provided to the financial institution managing the retirement account by October 30th of the year following the year of the owner's death; (4) all of the "countable" beneficiaries must be identifiable; and (5) all of the "countable" beneficiaries must be individuals.[10] As you can see, the first three requirements should be easy to satisfy. It is those last two requirements and

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[4] Reg §1.401(a)(9)-2, A-5.

[5] See generally, Reg. §§1.401(a)(9)-3; 1.401(a)(9)-5.

[6] *Id.*

[7] Reg. §1.401(a)(9)-4, A-3.

[8] See footnote 2.

[9] Reg. §1.401(a)(9)-5, A-5(a)(2); §1.401(a)(9)-3, A-4(a)(2).

[10] Reg. §1.401(a)(9)-4, A-5(b); §1.401(a)(9)-4, A-3.

what beneficiaries are “countable” that can be tricky to analyze in certain situations which I will discuss in more detail later in this article.

See-Through Trusts that meet these five requirements can be divided into two categories, “Conduit Trusts” and “Accumulation Trusts”. Conduit Trusts use the age of the primary/lifetime beneficiary to calculate the MRD.[11] Conduit Trusts are drafted with specific language that requires the trustee to withdraw any MRDs from the retirement account (and any other funds that are withdrawn by the trustee that exceed the MRD) and immediately distribute all such withdrawn funds to the primary beneficiary of the trust.[12]

In this way, the trust simply acts as a conduit for the withdrawn funds and the IRS views the primary beneficiary as the “true recipient” of the funds and therefore allows the primary beneficiary’s age to calculate the MRD. The only “countable” beneficiary of a Conduit Trust is the primary beneficiary. Unlike the Accumulation Trust (see below), there is no need to consider the remainder beneficiaries in a Conduit Trust.[13] Conduit Trusts have the double advantage of allowing a trustee to control the retirement account but still use the primary beneficiary’s life expectancy to calculate the MRD. However, the obvious disadvantage of Conduit Trusts for some clients is that there are required and automatic distributions to the primary beneficiary. Because of those automatic distributions, special needs trusts, or any other type of lifetime trust where the clients wish to restrict the beneficiary’s automatic access to money should not be designed to include the conduit language. Those types of situations will require the attorney to consider whether the trust can qualify as an Accumulation Trust.

An Accumulation Trust uses the age of the *oldest countable beneficiary* of the trust to calculate the MRD. In contrast to the Conduit Trust situation, remainder beneficiaries are countable beneficiaries for an Accumulation Trust. Further, all of the countable remainder beneficiaries must be identifiable and individuals to satisfy See-Through Trust requirements #4 & #5.[14] But which remainder beneficiaries count? To answer this

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[11] See Reg §1.401(a)(9)-5, A-7(c)(3), Ex. 2.

[12] *Id.*

[13] *Id.*

[14] See footnote 10.

question, I employ a technique espoused by retirement rules guru Natalie Choate[15] which I call the "chain test".[16]

Essentially, to determine the countable beneficiaries, you begin with the primary (lifetime) beneficiary as your first "link" in the chain. Then you analyze all the potential 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 is the last link in the countable beneficiary chain. To make this even more complicated, this test will not be relevant until after the retirement account owner has died.[17] This technical analysis technique is best explained with a few examples.

Assume that Ned Stark directed one of his IRA accounts to a special needs trust for his son, Bran (age 14), who is experiencing a disability after falling from a castle tower. Assume further that the special needs trust is designed so that upon Bran's death, the remaining trust assets will pay out to Ned's other children- Rob (age 24), Jon (age 23), Sansa (age 18), Arya (age 15), and Rickon (age 10). Ned Stark dies at age 50 survived by all of his children. In this simple example, the countable beneficiaries are: Bran (as the primary beneficiary) and the "immediately and outright" beneficiaries upon Bran's death- his siblings. All of these countable beneficiaries are identifiable (trust requirement #4) and individuals (trust requirement #5) so this special needs trust does qualify as an Accumulation Trust. The oldest beneficiary of these countable beneficiaries is Rob. Rob's age would be used to calculate the MRD that must be withdrawn by the trustee of the special needs trust each year.

Let's add on another layer of complexity. Assume the IRA is directed to a special needs trust for Bran, but upon Bran's death, the remaining trust assets are held in separate trusts for each of Ned's then- living children until they reach age 21. If a child dies prior to reaching age 21, the remaining assets of the "age 21 trust" are distributed to the child's descendants, by right of representation, and if the child has no descendants, to Ned's favorite charity, the "Winter Is Coming Foundation". Again, Ned dies survived by all of his children. In this example, the countable beneficiaries start with Bran and include the next layer of beneficiaries, the other five children. However, since at the time of Ned's death, three of the children (Sansa, Arya and Rickon) would not receive their share outright, we must go to the next layer of beneficiaries, their descendants. But at the time

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[15] Her treatise, *Life and Death Planning for Retirement Benefits* is a must-own book for anyone interested in learning more about this area of law.

[16] See section 6.3.08 of *Life and Death Planning for Retirement Benefits*, 7th edition (2011). See also, PLR 2004-38044.

[17] Reg. §1.401(a)(9)-4, A-4(a).

of Ned's death, they don't have any descendants, so we must keep going to the next layer which would be the charity. The countable beneficiaries in this example would be Bran, Rob, Jon, Sansa, Arya, Rickon, and the Winter Is Coming Foundation. The Foundation is not an individual and causes the special needs trust to fail trust requirement #5. The special needs trust would not qualify as an Accumulation Trust and the funds in the IRA would have to be completely withdrawn (and subject to income taxes) within five years of Ned's death.

As you can see with this example, embedded trusts (trusts that can come into existence for the benefit of remainder beneficiaries) can create complication to the analysis because we must analyze the potential remainder beneficiaries of those embedded trusts. Powers of Appointment similarly create complication because all of the potential appointees, as well as the takers in default are countable beneficiaries.[18] Essentially, the more layers of beneficiaries that must be counted, the longer the countable beneficiary chain, and the more chance of failing trust requirements #4 & 5.

There may be "hidden" beneficiaries that can wreak havoc on the analysis. Some practitioners warn that, because the term "descendants" includes adopted individuals under many state laws, including Oregon, there is a potential for failing trust requirement #4 (all countable beneficiaries must be identifiable).[19] To illustrate this, in the example above, because Sansa (or Arya or Rickon) could *at some point in the future* adopt a person who could be older than all of the other countable beneficiaries, that future adoptee is not identifiable at the time the trust is analyzed (after Ned's death) and the trust therefore fails requirement #4. There is also the argument that if, in our example, Bran's special needs trust is charged with it's allocated share of estate taxes and is allowed to use the retirement funds to pay those taxes, the estate is also a countable beneficiary, thereby failing trust requirement #5.[20] To my knowledge, the IRS has never hinted at taking the analysis so far, but cautious attorneys include provisions in their trusts like defining the term "descendants" to exclude older adoptees and prohibiting the use of retirement funds to pay estate taxes to override these concerns.

Finally, it is important to recognize that whether the Trust qualifies as a See-Through Trust depends on facts as they exist *after the death* of the retirement account owner, not at the time the trust is drafted.[21] While attorneys who design the lifetime trust as a Conduit Trust can be confident that the MRD will be based on the primary beneficiary's

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[18] See, e.g. PLRs 1999-03050; 2002-35038; 2004-38044.

[19] See Chapter 6, paragraph 6.2.07 in Choate book for discussion.

[20] See, e.g. PLR 9809059 and Chapter 6, paragraph 6.2.10 in Choate book.

[21] Reg. §1.401(a)(9)-4, A-4(a).

life expectancy, the same is not true for Accumulation Trusts. Because the analysis of a See-Through Accumulation Trust depends on the identity of remainder beneficiaries who may or may not be alive at the time of the retirement account owner's death, there are no guaranteed outcomes, and attorneys should tread lightly when advising clients about the income tax outcomes.