

Natalie Choate Special Report:

MAKING RETIREMENT BENEFITS PAYABLE TO TRUSTS

This seminar handout is the full text of Chapter 6, plus selected other sections and forms, from the author's book *Life and Death Planning for Retirement Benefits* (www.ataxplan.com; see Appendix C). Copyright 2007 by Natalie B. Choate. All rights reserved.

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Abbreviations Used in this Handout

§	Refers to a section of the Internal Revenue Code of 1986, as amended through 8/17/07, unless otherwise indicated.
¶	Refers to a section of the author’s book <i>Life and Death Planning for Retirement Benefits</i> (6 th ed., 2006; see Appendix C). If the section number begins with “¶ 6.,” it can be found elsewhere in this handout. If the reference does not begin with “¶ 6.,” but mentions Appendix A, it can be found in Appendix A of this handout. Otherwise it refers to a section of the book not reproduced here.
ADP	Applicable Distribution Period. ¶ 6.2.00.
Code	Internal Revenue Code of 1986.
DNI	Distributable net income. ¶ 6.4.02.
IRA	Individual Retirement Account. § 408.
IRD	Income in respect of a decedent. ¶ 2.3 (Appendix A).
IRS	Internal Revenue Service.
IRT	Individual retirement trust (trusteed IRA). ¶ 6.1.06.
MRD	Minimum Required Distribution. ¶ 6.2.00.
O/R-2-NLP	Outright to now-living person. ¶ 6.3.06.
PLR	IRS private letter ruling.
PPA '06	Pension Protection Act of 2006.
QRP	Qualified Retirement Plan. § 401(a).
RBD	Required Beginning Date. ¶ 6.2.00.
Reg.	Treasury Regulation.

should establish the Beneficiary Finalization Date (§ 6.3.03) as the deadline for exercise of the amendment power.

6.3.11 Planning choices: Trust for disabled beneficiary

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

- A. Conduit trust.** A conduit trust (§ 6.3.05) is not suitable if the beneficiary must qualify for welfare. The MRDs would have to be distributed to the beneficiary, and would be considered available income or assets to the beneficiary, thus forfeiting eligibility for welfare benefits. However, if qualification for these benefits is not an issue (for example, because the family is wealthy and intends to provide for all of the beneficiary's care), a conduit trust could be suitable, especially if the donor wants the remainder interest to pass to charity.

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

- B. Accumulation O/R-2-NLP Trust.** Under most forms of "supplemental needs" trusts (designed to benefit a disabled beneficiary without causing loss of the beneficiary's eligibility for need-based government benefit programs), the trustee has discretion regarding whether to distribute trust funds to or for the benefit of the disabled individual, but is prohibited from distributing funds for needs that are provided by the government programs such as support and health care. Such a trust would be considered an accumulation trust for MRD purposes, but would still qualify as a see-through if the trust principal passes outright at the disabled beneficiary's death to other now-living individuals, such as the disabled beneficiary's siblings. See § 6.3.06.

If an O/R-2-NLP trust is used, a charity cannot be named as remainder beneficiary. The chosen remainder beneficiaries should be (as siblings typically are) individuals who are close in age to (or younger than) the disabled beneficiary, since the life expectancy of the oldest member of the group will be the ADP. Thus, drafting this type of trust is "easy" if the disabled individual has living siblings who are younger or close in age, but impossible if there are no such suitable younger or close-in-age individual remainder beneficiaries.

- C. Accumulation 100 percent grantor trust.** A trust that gives the beneficiary the unlimited right to withdraw all the trust property at any time would be treated as a 100 percent grantor trust (§ 6.3.08). It could be a suitable way to provide for a mentally handicapped beneficiary who (1) does not need to qualify for need-based government benefits (because this type of trust would disqualify him) and (2) can exercise the right of withdrawal only through a legal guardian, especially if the guardian is also the trustee. For this type of beneficiary, this type of trust provides the benefits of a discretionary trust while allowing the life expectancy of the handicapped beneficiary to be the ADP. This can be particularly helpful if the beneficiary has no siblings or issue, and is not likely to have issue, where the only likely remainder beneficiaries are either much older individuals, the beneficiary's own estate, or charities.
- D. Charitable remainder trust with payments to special needs trust.** If the donor is charitably inclined, consider making the retirement benefits payable to a charitable remainder trust (CRT; see § 664) for the life benefit of the disabled beneficiary. The retirement benefits can be paid to the CRT free of income taxes, and the annuity or unitrust payments can be paid to a special needs trust for the disabled beneficiary rather than outright to him or her (as is normally required for CRTs) if various requirements are met, according to Rev. Rul. 2002-20, 2002-1 I.R.B. 794. For where to read more on charitable giving with retirement benefits, see Appendix C.

6.3.12 *Planning choices: Trusts for minors*

Here are options available for a trust intended to provide for minor beneficiaries, when qualifying for see-through trust status is an important goal (§ 6.2.01). Which type is best depends on the purpose of the trust: Is the trust to be the major source of support for an orphaned family, or is it just providing extra spending money for well-to-do children whose support is otherwise taken care of? Is the donor's main goal to be sure that the "stretchout" payout method is available, so the benefits become the minors' own retirement plans eventually? Or is the money most likely to be spent during the beneficiaries' childhood, for their support, education, and care? Are the benefits and nonbenefit assets each substantial enough to justify establishing separate trusts, one for the benefits and one for the other assets? Are the benefits substantial enough to justify establishing a separate trust for each minor beneficiary, or is the "family pot trust" approach better?

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

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

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

9808043. For more on this, see Choate, N., “Mysteries of IRD,” *Tax Management Memorandum*, Vol. 38, No. 20, p. 235 (Tax Management Inc., Washington, D.C., 9/29/97). For planning purposes, however, it is wise to assume that the transfer of retirement benefits out of an estate or a trust to a beneficiary in fulfillment of a pecuniary bequest will trigger immediate realization of income under § 691(a)(2). Accordingly, drafters should avoid the problem; see ¶ 6.5.01, #7.

6.5 Putting it All Together

6.5.01 *Trust as beneficiary: Checklist*

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

1. Does the client really need to name a trust as beneficiary, or is there a way to achieve the planning goals without incurring the risks and complications of naming a trust?

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

2. If any trust provisions deal with retirement benefits, you need to define “retirement benefits.” See Form 4.9, Appendix B, which uses different definitions for different purposes.
3. If the trust is intended to qualify for the federal estate tax marital deduction, see ¶ 3.3.01–¶ 3.3.06 (Appendix A) and ¶ 6.1.02(E).
4. If the trust’s dispositive terms will distinguish between “income” and “principal,” or if the trustee’s compensation will be based on specified percentages of income and principal, consider how these terms will apply to the retirement plan and to distributions from it and draft accordingly. ¶ 6.1.02.
5. If see-through trust status is important, make sure the trust complies with IRS’s MRD trust rules. ¶ 6.2–¶ 6.3.
6. If the trust is to be divided into shares or subtrusts upon the client’s death, see ¶ 6.3.01 regarding whether, if benefits may be allocated only to one share, beneficiaries of the other shares are disregarded for MRD purposes, and ¶ 6.3.02 regarding how the “separate accounts” rule applies to trusts. If the benefits are to pass to multiple beneficiaries, and separate accounts treatment is important, leave the benefits to the various beneficiaries directly (i.e., do not leave the benefits to a trust to be divided among the multiple beneficiaries) in the beneficiary designation form. See Form 3.4 (designation of contingent beneficiary), Appendix B, for an example of how to leave benefits in separate shares directly to separate trusts established under a single trust instrument. For the same reason, if leaving

benefits to a trust for the participant's surviving spouse, and the trust is to pass outright to the participant's issue on the death of the surviving spouse, name the trust as beneficiary only if the participant's spouse survives the participant; name the issue directly as contingent beneficiary if the spouse does not survive. See ¶ 6.3.02 and Form 3.4, Appendix B.

7. To avoid the issue of whether funding a pecuniary bequest with IRD is a taxable transfer (¶ 6.4.08), avoid having retirement benefits pass through a pecuniary funding formula. If benefits must pass to a trust, make them payable to a trust that will not be divided up. If benefits are going to a trust that will be divided, either specify clearly (in both the beneficiary designation form and the trust instrument) which trust share these retirement benefits go to (so that the benefits pass to the chosen share directly, rather than through the funding formula), or use a fractional formula (fulfillment of which does not trigger immediate realization of IRD) rather than a pecuniary formula (which may).
8. Including a spendthrift clause poses no MRD issues, even in a conduit trust. Since the Code itself imposes spendthrift restrictions on retirement plans (see § 401(a)(13)), such clauses are favored by government policy.

6.5.02 Boilerplate provisions for trusts named as beneficiary

Many practitioners would like to have a blanket trust form that will work for all clients' situations without further fine tuning. This approach can be hazardous when dealing with retirement benefits.

It makes sense, if qualification for see-through trust status is important, to include a "boilerplate" provision either prohibiting the use of the retirement benefits for payments to the estate for debts, expenses, or taxes, or requiring that no such payments may be made from the retirement benefits on or after the Beneficiary Finalization Date. See ¶ 6.2.10(A), (C), and Form 4.2, Appendix B. If there are no assets available to pay debts, expenses, and taxes other than retirement benefits, consider specifying that only certain plans may be used for this purpose, so that only the plans authorized to be used to pay the debts and expenses will be "tainted," and the other(s) can be exempted from this problem; or have the participant take withdrawals during life so his estate will have sufficient nonretirement assets to pay these items (and to remove the income tax money from the gross estate for estate tax purposes).

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

6.5.03 Advance rulings on see-through trust status

One expensive and time-consuming way to achieve certainty regarding the see-through status of a trust would be to seek a private letter ruling on this point while the client is still living. The IRS