# Trusts as Beneficiaries of Retirement Benefits

Rockland County Estate Planning Council

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- Bruce Steiner has over 35 years of experience in the areas of taxation, estate planning, business succession planning and estate and trust administration.

- He is a frequent lecturer at continuing education programs for bar associations, CPAs and other professionals. He is a commentator for Leimberg Information Services, Inc., is a member of the editorial advisory board of *Trusts & Estates*, is a technical advisor for *Ed Slott's IRA Advisor*, and has written numerous articles for *Estate Planning*, *BNA Tax Management's Estates, Gifts & Trusts Journal*, *Trusts & Estates*, *Journal of Taxation*, *Probate & Property*, *TAXES*, *CPA Journal*, *CLU Journal* and other professional journals.

- Bruce has been quoted in various publications including *Forbes*, *The New York Times*, the *Wall Street Journal*, the *Daily Tax Report*, *Investment News*, *Lawyers Weekly*, *Bloomberg's Wealth Manager*, *Financial Planning*, *Kiplinger's Retirement Report*, *Newsday*, *New York Post*, *Naples Daily News*, *Individual Investor*, *Fox Business*, *TheStreet.com*, and *Dow Jones (formerly CBS) Market Watch*.

- Bruce has served on the professional advisory boards of several major charitable organizations and was named a New York Super Lawyer in 2010, 2011, 2012, 2013, 2014 and 2015.

# Why leave retirement benefits in trust

- The same reasons for leaving other assets in trust apply to retirement benefits
- Keeps the assets out of the beneficiaries’ estates for estate tax purposes
- Provides increased protection against creditors, predators, and spouses

# Disadvantages of leaving retirement benefits in trust

- Compressed income tax rates for trusts
- Legal and accounting fees
- Trustees’ commissions
- Annual fiduciary income tax returns
- Complexity

# Clark v. Rameker

- Supreme Court held that inherited IRAs are not protected under the Federal exemptions of the bankruptcy law
- Inherited IRAs may be protected in bankruptcy, or against creditors outside of bankruptcy under state law
- You may obtain better protection against creditors by leaving retirement benefits in trust rather than outright

# Inherited IRA

- Allows distributions to be stretched over a long period of time
- Increases wealth to future generations

# Required distributions

- The oldest beneficiary of the trust is generally considered the designated beneficiary
- None of the retirement benefits accumulated in the trust can ever go to anyone older than the oldest beneficiary, or to anyone other than an individual, or another trust subject to the same restrictions
- No charities

# Required distributions

- If the trust does not qualify as a designated beneficiary:
- Death before required beginning date:  5-year rule.  Complete distribution by the end of the 5$^{th}$ calendar year after death
- Death after required beginning date:  required distributions over the life expectancy of the IRA owner (as if the IRA owner hadn't died

# Flexibility of trusts for issue

- The trustees may distribute the income and principal to or for the benefit of the beneficiary and his or her issue, or accumulate the income
- The beneficiary may have a power of appointment
- The beneficiary may become a trustee
- The beneficiary may have the power to remove and replace his/her co-trustee (provided the replacement trustee is not related or subordinate)

# Income taxation of trusts

- The income of a trust is generally taxable to the beneficiaries to the extent distributed, and to the trust to the extent it is not distributed

- Distributions from a traditional IRA are generally included in distributable net income (DNI), and treated as income for tax purposes

# Income tax rates

- Trusts reach the top tax rate (39.6% on ordinary income and 20% on long-term capital gains and qualified dividends) at $12,400 of taxable income
- Individuals do not reach the top income tax rate until $415,050 (single) or $466,950 (joint)

# 3.8% net investment income tax

- Trusts pay the 3.8% net investment income tax on income above $12,400

- Individuals do not pay this tax until $200,000 (single) or $250,000 (joint)

# Should trustees distribute income?

- Trustees may consider income taxes and the net investment income tax in deciding whether to make distributions
- Amounts distributed will be included in the recipient's estate for estate tax purposes, and will be subject to the recipient's creditors and spouses
- Amounts retained in the trust will not be included in the beneficiaries' estates, and will be better protected against their creditors and spouses

# Roth conversions

- Distributions from a Roth IRA are generally exempt from income tax, and are not included in the trust's DNI
- This allows the trustees to accumulate the distributions from a Roth IRA without having to pay tax on them at the trust's income tax rates
- If the trust makes distributions, the Roth IRA benefits will retain their character as tax-free Roth IRA benefits

# State income tax rates

- The top New York state income tax rate is 8.82%
- The top New York City income tax rate is 3.876%
- The top New Jersey income tax rate is 8.97%
- The top California income tax rate is 13.3%

# State income taxation of trusts

- Different states have different ways of determining whether a trust is a resident trust
- New York and New Jersey determine the residence of a trust based upon the residence of the grantor or decedent
- Other states determine the residence of a trust based upon the residence of the trustee, or where the trust is administered
- New York and New Jersey exempt a resident trust if there is no trustee in the state, no real or tangible property in the state, and no income from sources in the state
- New York has a throwback rule

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# Requirement for the trust to be able to stretch the distributions

- Assuming the trust qualifies, it can stretch distributions over the life expectancy of the oldest beneficiary of the trust
  - The trust must be a valid trust, or would be if it had corpus
  - The trust must be irrevocable upon the employee's or IRA owner's death
  - The beneficiaries must be identifiable
  - By October 31 of the year after death, the trustee must give the plan administrator or custodian a copy of the trust, or certain information as to the trust and beneficiaries

# Who is considered a beneficiary

- The beneficiaries must be individuals
- Remainder beneficiaries are considered
- Contingent beneficiaries are considered, even if remote
- Permissible appointees are considered
- A “mere successor beneficiary” is not considered
- Takers by operation of law are disregarded

# Eliminating beneficiaries

- You can eliminate a beneficiary by September 30th of the year following death
  - Disclaimer
  - Decanting
  - Paying off any beneficiaries entitled to cash bequests

# Two Types of Trusts

- Accumulation trusts
  - The key is to determine who counts as a beneficiary
  - All beneficiaries count except a “mere successor beneficiary”
- Conduit trusts

# Conduit trusts

- A trust that requires that any amounts received from the IRA be distributed to the beneficiary on a current basis is called a conduit trust
- Successor beneficiaries are disregarded
- If the spouse is the beneficiary, the spouse's life expectancy can be recalculated annually

# Disadvantages of the conduit trust

- It forces out all of the distributions
- Except for the spouse, if the beneficiary lives to life expectancy, nothing will be left in the trust
- All of the trust assets, which could have been kept out of the beneficiary's estate and protected against creditors and spouses, will be included in the beneficiary's estate, and exposed to creditors and spouses

# Advantages of the conduit trust

- Provides greater flexibility in naming successor beneficiaries
  - Charities
  - Broad powers of appointment
  - General powers of appointment
- Limits beneficiary’s ability to take a lump-sum distribution

# The marital (QTIP) trust as beneficiary

- The IRA and the marital trust must both qualify for the marital deduction
- The spouse must be entitled to all of the income from both the IRA and the trust
- No one other than the spouse may receive any benefits during the spouse's lifetime
- A valid QTIP election must be made on the estate tax return

# Disadvantages of the QTIP trust as beneficiary

- The stretch is limited to the spouse’s life expectancy
- The opportunity for a rollover is lost
- The opportunity for a Roth conversion is lost
- With a $5,450,000 (indexed) Federal estate tax exclusion amount and portability, very few IRA owners will name a QTIP trust as beneficiary

# Noncitizen spouses

- To obtain the marital deduction for a noncitizen spouse, assets must pass to a qualified domestic trust (QDOT)
- The spouse can create a QDOT and transfer assets to the QDOT
- The spouse can agree to contribute to a QDOT the principal portion of each payment under a nonassignable annuity
- The regulations say that the spouse can do the same for an IRA

# The credit shelter trust as beneficiary

- An IRA owner may leave retirement benefits to the credit shelter trust if he or she doesn't have enough other assets to fully fund the credit shelter trust
- There is a tradeoff between the income tax benefits of leaving the retirement benefits to the spouse and the potential estate tax benefits of fully funding the credit shelter trust
- With a $5,450,000 (indexed) estate tax exclusion amount, and portability, very few clients will leave IRA benefits to the credit shelter trust for tax reasons

# Transferring retirement benefits to a trust

- There is no authority permitting an IRA owner to transfer an IRA to a trust
- The IRS allowed an IRA owner to place "directions" on the custodian that limited access to the IRA
- The IRS allowed a beneficiary to transfer an inherited IRA to a grantor trust

# Common mistakes to avoid

- Older contingent beneficiaries
- Powers of appointment exercisable in favor of older beneficiaries
- Failure to provide the necessary documentation to the custodian by October 31 of the year after death
- Trusts taking lump-sum distributions

# Changing an irrevocable trust

- Exercising a power of appointment
- Releasing a power of appointment to eliminate unwanted beneficiaries
- Decanting -- transferring trust assets to another trust
- Decanting can eliminate unwanted beneficiaries
- The IRS may not respect reformation of a trust

availability of comparables for almost anything on Internet auction sites, even the purchase of "priceless" items can support a partial tax deduction if the charity reviews the similar items and issues the appropriate letter.

So enjoy the season: Donate happily, bid liberally and deduct carefully.

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## Endnotes

1. Internal Revenue Code Section 170(e)(1)(B)(i)(I).
2. IRC Section 170(f)(11)(C).
3. Treasury Regulations Section 1.170A-13(c)(3).
4. Treas. Regs. Section 1.170A-1(g).
5. Treas. Regs. Section 1.170A-7(d) Ex. (1).
6. Treas. Regs. Section 1.170A-13(f).
7. Treas. Regs. Section 1.170A-13(f)(10).
8. *Van Dusen v. Commissioner,* 136 T.C. No. 25 (2011).
9. Treas. Regs. Section 1.170A-13(f)(2).
10. Treas. Regs. Section 1.170A-1(h)(4) and IRC Section 6115.

RETIREMENT BENEFITS

# IRS Rules "No Problem" If IRA Trust Runs Out Of Beneficiaries

By Bruce D. Steiner, an attorney with Kleinberg, Kaplan, Wolff & Cohen, P.C., in New York

If an individual retirement account is payable to a trust, the IRA benefits can, generally, be stretched out over the life expectancy of the oldest beneficiary of the trust.[1] For this purpose, any person who could receive amounts distributed from the IRA and accumulated in the trust is considered a beneficiary. Therefore, remainder beneficiaries and permissible appointees are, generally, considered beneficiaries.[2]

For example, say an IRA is payable to the children in separate trusts, and one child dies without leaving any issue. If the balance of the deceased child's trust is added to the other children's trusts, then each child is a beneficiary of the other children's trust.[3]

A permissible appointee is considered a beneficiary. Thus, in the above example, if each child has a power of appointment (POA), if the IRA owner wants to obtain a stretchout over the oldest child's life expectancy, the class of permissible appointees must exclude anyone older than the oldest child.

## Remote Contingent Beneficiary

The Internal Revenue Service considers even a remote contingent beneficiary as a beneficiary for this purpose. In Private Letter Ruling 200228025 (April 18, 2002), an IRA was payable to the grandchildren, subject to trusts to age 30. If both grandchildren died before age 30, the balance of the trust was payable to various contingent beneficiaries, the oldest of which was age 67. Even though the 67-year-old's interest was remote (both grandchildren would have to die before age 30, and the 67-year-old would have to be living at the death of the surviving grandchild), the IRS ruled that the 67-year-old was a beneficiary, so the IRA had to be distributed over his life expectancy.

## Conduit Trust

There's an exception to the general rule whereby a "mere successor beneficiary" whose interest is contingent on the death of a prior beneficiary is disregarded. To come within this exception, all of the amounts distributed from the IRA must be paid out on a current basis. None of the distributions from the IRA can be accumulated in the trust for distribution to a subsequent beneficiary.[4] This is known as a "conduit trust."

Because a conduit trust allows subsequent beneficiaries to be disregarded, it facilitates qualification for the stretchout. However, it forces out the IRA benefits over the beneficiary's life expectancy, thus pushing the IRA benefits into the beneficiary's estate and exposing them to the beneficiary's creditors and spouses.

## PLR 201320021

For many years, there's been a question as to what would happen if a trust were to run out of beneficiaries. No matter how many levels of contingent beneficiaries are provided, that's always a possibility. One solution has been to terminate the trust when there's only one living issue of the IRA owner remaining. However, that could jeopardize the purpose of the trust in a small family. The last living issue could subsequently have children or exercise a POA, or that person's parent could also have another child.

A stricter solution has been to terminate the trust when only one beneficiary is alive at the IRA owner's death.[5] However, this throws the trust assets into the estates of the youngest generation alive at the IRA owner's death and exposes it to their creditors and spouses.

In PLR 201320021 (Feb. 19, 2013), the IRS disregarded the persons who would receive the balance of the trust if there were a complete failure of the trust beneficiaries.

In this ruling, an IRA owner was survived by her mother, her brother and one child. She left her IRA in trust for her child. There were no contingent beneficiaries of the trust. If her child died without leaving any issue and without exercising any POA he might have had, the balance of the trust had to go to someone. Nevertheless, the IRS ruled that since the child was the only beneficiary of the trust, he was the designated beneficiary, and his life expectancy would be used to determine the required distributions. It didn't matter that the IRA owner's mother or brother might receive the balance of the trust by operation of law on the child's death.

If PLR 201320021 is correct, it removes an obstacle to the use of discretionary trusts, particularly in smaller families. While PLRs aren't binding on the IRS, except with respect to the taxpayers to whom they're issued, because the taxpayer requested a ruling on this point, it provided a strong indication of the IRS' view on this issue.

## Endnotes

1. For a detailed discussion of trusts as beneficiaries of retirement benefits, *see* Bruce D. Steiner, "Trusts as Beneficiaries of Retirement Benefits," 29 *BNA Tax Mgmt. Estates, Gifts & Trusts J.* No. 2, at p. 108 (March/April 2004).
2. Treasury Regulations Section 1.401(a)(9)-5 A-7(c)(3), Example 1.
3. Private Letter Ruling 200235038 (June 4, 2002).
4. Treas. Regs. Section 1.401(a)(9)-5 A-7(c)(3), Example 2.
5. Natalie B. Choate, *Life and Death Planning for Retirement Benefits* (7th ed. 2011), par. 6.3.08.

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# Trusts as Beneficiaries of Retirement Benefits

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There are many reasons for leaving assets in trust rather than outright. These include protection from creditors, protection from spouses, asset management, control over distributions, Medicaid, and keeping the assets out of the beneficiaries' estates for estate tax purposes. These reasons apply to qualified plan and IRA benefits (collectively referred to as retirement benefits) in the same way as other assets. This article explores the tradeoffs and special considerations involved in leaving retirement benefits in trust rather than outright.

## REQUIRED DISTRIBUTIONS

A designated beneficiary of retirement benefits must generally take the minimum required distributions ("MRDs") over his or her life expectancy.[1] Alternatively, a beneficiary who is also the surviving spouse can roll the benefits over to his or her own IRA,[2] or remain as beneficiary and postpone taking distributions until the calendar year when the deceased spouse would have reached age 70½.[3]

If a trust is the beneficiary, assuming all of the trust beneficiaries are individuals, the trust beneficiary with the shortest life expectancy (i.e., the oldest beneficiary) is treated as the designated beneficiary on whose life expectancy the MRDs are based.[4]

## WHO IS A BENEFICIARY

In order to determine the oldest beneficiary of a trust, it is first necessary to identify the trust beneficiaries.

The regulations explain that a contingent beneficiary is generally considered a beneficiary for this purpose.[5] A "mere successor beneficiary" is not considered a beneficiary. However, a person who has any right (including a contingent right) beyond being a mere successor beneficiary is considered a beneficiary. Thus, for example, if one person has a right to all income for life, and a second person has a right to the principal (including the principal distributed during the first beneficiary's lifetime), both are considered beneficiaries.[6]

*Remainder beneficiaries.* The regulations give an example illustrating that remainder beneficiaries are taken into account.[7] Similarly, before the final regulations were issued, the Internal Revenue Service took trust remainder beneficiaries into account in Rev. Rul. 2000-2.[8]

*Remote contingent beneficiaries.* Remote contingent beneficiaries were considered beneficiaries for this purpose in PLR 200228025, but not in previous rulings.[9] In PLR 200228025, the IRA owner left the IRA to separate trusts for the benefit of her two minor grandchildren. If both grandchildren died before age 30, the balance of the trust was payable to contingent beneficiaries, the oldest of whom was age 67. Even though the 67-year-old's interest was extremely remote, the Service considered her to be a beneficiary, and thus the measuring life for purposes of determining the MRDs.

Private letter rulings have no precedential effect.[10] One commentator argues that a remote contingent beneficiary should be disregarded if there is less than a 5% probability that the trust would pay out to him or her.[11] However, until this issue is resolved, the conservative approach is to avoid any contingent beneficiaries who are older than the desired designated beneficiary.

Presumably the Service will disregard takers by operation of law. If takers by operation of law were considered beneficiaries, it would be virtually impossible for any trust to qualify. In this regard, Regs. §1.401(a)(9)-4 A-1 states that "the fact that an employee's interest under the plan passes to a certain individual under a will or otherwise under applicable state law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan."

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[1] §401(a)(9)(B)(iii); Regs. §1.401(a)(9)-3 A-1(a) and -5 A-5. All section references are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations thereunder.

[2] §402(c)(9).

[3] §401(a)(9)(B)(iv)(I); Regs. §1.401(a)(9)-3 A-3(b)(2).

[4] Regs. §§1.401(a)(9)-4 A-5 and -5 A-7.

[5] Regs. §1.401(a)(9)-5 A-7(b).

[6] Regs. §1.401(a)(9)-5 A-7(c).

[7] Regs. §1.401(a)(9)-5 A-7(c)(3) *Ex. 1.*

[8] 2000-1 C.B. 305.

[9] E.g., PLR 200040035.

[10] Regs. §601.201(*l*)(1)

[11] Martin Silfen, quoted in David W. Polstra, "Accumulation Trusts as Beneficiaries of IRAs—A Fateful Twist for the Unwary," *CCH J. of Retirement Planning*, Mar. 2003, at 35, 39.



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*Permissible appointees.* Suppose a beneficiary has a power of appointment. Are the permissible appointees considered beneficiaries?

In at least some jurisdictions, where the trustees have complete discretion to distribute the principal, they can distribute the principal to another trust.[12] Suppose a beneficiary of the first trust has a power of appointment over the second trust. Are the permissible appointees of the second trust considered beneficiaries?

In the example in the regulations, no one had the power to appoint the principal of the trust to anyone other than the income beneficiary, and the remainder beneficiaries were all younger than the income beneficiary. In that case, the income beneficiary was treated as the oldest beneficiary of the trust.[13]

Similarly, the Service has approved trusts in which the powers of appointment cannot be exercised in favor of anyone older than the desired designated beneficiary, and the trustees were not permitted to distribute the trust assets to another trust in which anyone older than the desired designated beneficiary could be a beneficiary or a permissible appointee.[14] Accordingly, unless and until the issue is resolved more favorably, the conservative approach is to incorporate the restrictions of PLRs 200235038 through 200235041 and not have any permissible appointees (or trusts with permissible appointees) who are older than the desired designated beneficiary, or who are not individuals.

An even more conservative approach is to protect against the possibility that the trust assts might pass to an older person by operation of law. This can be done in several ways. One way is for the trust assets to vest in the last living beneficiary. Another way is to require the last living beneficiary to exercise a testamentary power of appointment in favor of persons younger than the desired designated beneficiary.[15] Still another way is to give the trustees the power to expand the class of beneficiaries upon the death of the last living beneficiary, so long as the additional beneficiaries are all younger than the desired designated beneficiary.

*Conduit trusts.* The conduit trust is an exception to the general rule that all beneficiaries of a trust are considered. In a conduit trust, the trustees are required to distribute the MRDs (as well as any distributions in excess of the MRDs) to the beneficiaries of the trust on a current basis so that no amounts distributed from the qualified plan or IRA during the current beneficiaries' lifetimes are accumulated for the benefit of subsequent beneficiaries. In that case, the subsequent beneficiaries are disregarded.[16] The conduit trust is discussed in greater detail in the context of the various types of trusts.

## QTIP TRUST

By naming a QTIP trust as the beneficiary, an IRA owner can control the ultimate disposition of the principal while still obtaining the marital deduction for the IRA benefits. Assuming the spouse is the oldest beneficiary of the trust, distributions can be stretched out over the spouse's life expectancy. Deferral of estate tax by use of the marital deduction may be especially desirable now that the highest estate tax rate is scheduled to decrease from 49% in 2003 to 48% in 2004, 47% in 2005, 46% in 2006 and 45% in 2009,[17] and the estate tax exempt amount is scheduled to increase from $1 million in 2003 to $1.5 million in 2004-05, $2 million in 2006-08 and $3.5 million in 2009. There is no estate tax in 2010. However, the estate tax returns in 2011, with a $1 million exempt amount and a 55% top rate.[18] In addition, about one-third of the states have decoupled from the Federal estate tax changes under EGTRRA. In these states, the estate tax rates may increase.[19]

The tradeoff for naming a QTIP trust as beneficiary is generally a substantial loss of income tax deferral. If the spouse is the plan beneficiary, he or she can roll the benefits over into his or her own IRA,[20] possibly convert to a Roth IRA,[21] name new beneficiaries, and obtain a longer stretchout period both during the spouse's lifetime and after the spouse's death. Thus, if the participant or IRA owner is willing to permit the spouse to control the retirement benefits, he or she should consider naming the spouse as the beneficiary, even if the balance of the marital share passes in the form of a QTIP trust.

The ability to convert to a Roth IRA is particularly valuable, especially if the IRA owner has sufficient

[12] N.Y. EPTL §10-6.6; Alaska Statutes §13.36.157; *Matter of Spencer,* 232 N.W.2d 491 (Iowa 1975); *Phipps v. Palm Beach Trust Co.,* 142 Fla. 782, 196 So. 299 (1940); *see Matter of Wold,* 310 N.J. Super. 382 (Ch. Div. Middlesex Co. 1998); *National State Bank of Newark v. Morrison,* 9 N.J. Super. 552 (Ch. Div. 1950); *Guild v. Mayor,* 87 N.J. Eq. 38 (1916).

[13] Regs. §1.401(a)(9)-5 A-7(c)(3) *Ex. 1.*

[14] PLRs 200235038 through 200235041.

[15] A power of appointment that the power holder is required to exercise is an imperative power of appointment. *See, e.g.,* N.Y. EPTL §10-6.4(b). If the power holder does not exercise it, the power devolves on the court. *See, e.g.,* N.Y. EPTL §10-6.8(a)(2). This is analogous to the doctrine of cy pres in the charitable context.

[16] Regs. §1.401(a)(9)-5 A-7(c)(3) *Ex. 2.*

[17] §2001(c)(2)(B).

[18] §2010(c).

[19] Bruce D. Steiner, "Coping With the Decoupling of State Estate Taxes After EGTRRA," 30 *Estate Planning* 167 (April 2003).

[20] §402(c)(9).

[21] §408A(c)(3)(B).




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nonretirement assets with which to pay the income tax on the conversion. A surviving spouse may be able to convert to a Roth IRA even if neither spouse could convert while both spouses were alive.

The Service looks at the IRA itself as the asset which must qualify for the marital deduction. Thus, if the IRA is payable to a QTIP trust, the spouse must be entitled to all of the income of both the QTIP trust and the IRA on a current basis.[22]

If the spouse is relatively young, the internal income of the IRA may exceed the minimum required distributions (MRD). For example, if the IRA is $1 million, and the MRD is $30,000, but the internal income of the IRA is $40,000, then the trustees of the QTIP will generally withdraw $40,000 from the IRA and distribute the entire $40,000 to the spouse.

Rev. Rul 2000-2 points out that a QTIP trust need not require that all of the income be paid to the spouse. It is sufficient if the spouse has the right to require the trustees to distribute the income.[23] Thus, in the above example, if instead of requiring that all of the income of the QTIP trust be distributed to the spouse, the Will instead gave the spouse the power to compel the distribution of all of the income, then (if the spouse did not exercise that power), the trustees need only withdraw the $30,000 MRD from the IRA. However, this alternative may not have much practical significance, since the QTIP trust is not likely to be the beneficiary except in cases where control over the principal is an important objective for the IRA owner, and in those cases the spouse is likely to demand all of the income.

Where the MRD exceeds the internal income of the IRA, the QTIP trust can retain the difference as principal. For example, if the MRD is $50,000 and the internal income of the IRA is $40,000, the trustees of the QTIP trust must withdraw $50,000 from the IRA and distribute $40,000 to the spouse, while retaining the remaining $10,000 in the trust.

One can argue that it should be sufficient if the QTIP trust as a whole qualifies for the marital deduction. In other words, in the first example, instead of having to withdraw $40,000 from the IRA, arguably it should be sufficient if the trustees withdraw the $30,000 MRD from the IRA and distribute it to the spouse, so long as the trustees distribute $10,000 of principal to the spouse out of other assets of the trust. This is consistent with Regs. §§20.2056(b)-5(f)(5) and -7(d)(2), which allow the spouse's beneficial enjoyment to be satisfied with respect to non-income producing assets if the spouse can require payments out of other assets of the trust. However, it is inconsistent with both Rev. Rul. 2000-2 and its predecessor, Rev. Rul. 89-89.[24]

## CONDUIT QTIP TRUST

The conduit QTIP trust is a variation of the QTIP trust. In a conduit QTIP trust, all of the MRDs (as well as any distributions in excess of the MRDs) must be paid to the spouse, even if they exceed the income.

Since none of the MRDs during the spouse's lifetime can ever be accumulated for the ultimate benefit of anyone but the spouse, the spouse is treated as the sole beneficiary of the IRA.[25] This offers two income tax advantages. No MRDs are required until the year in which the IRA owner would have reached age 70½.[26] Once the spouse is required to begin taking distributions, his or her life expectancy can be recalculated each year, thus resulting in smaller MRDs.[27]

Notwithstanding the income tax benefits of the conduit QTIP trust over the standard QTIP trust, the conduit QTIP trust may not have much practical significance. In the conduit QTIP trust, where the MRDs exceed the internal income of the IRA, the portion of the MRDs that represent principal must be paid to the spouse, thus reducing the amount of principal subject to the IRA owner's control.

## CREDIT SHELTER TRUST

Sometimes a married participant's nonretirement assets are less than the estate tax exempt amount. In other words, he or she does not have enough nonretirement assets to fully fund the credit shelter trust. He or she must choose between the income tax benefits of naming the spouse as beneficiary and the potential estate tax benefits of fully funding the credit shelter trust or otherwise taking advantage of the entire estate tax exempt amount.

From an income tax standpoint, it is generally advantageous to leave the retirement benefits to the spouse. As previously noted, the spouse can roll them over to his or her own IRA,[28] name new beneficiaries, possibly convert to a Roth IRA,[29] and obtain a longer stretchout period. Alternatively, the spouse can remain as beneficiary, and wait until the year in which the

[22] Regs. §§20.2056(b)-5(f)(8) and -7(d)(2).

[23] Rev. Rul. 2000-2, 2000-3 I.R.B. 305.

[24] 1989-2 C.B. 231.

[25] Regs. §1.401(a)(9)-5 A-7 *Ex. 2.*

[26] §401(a)(9)(B)(iii); Regs. §1.401(a)(9)-3 A-3(b).

[27] Regs. §1.401(a)(9)-5 A-5(c)(2).

[28] §402(c)(9).

[29] §408A(c)(3)(B).



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participant would have reached age 70½ before having to begin taking distributions.[30]

However, from an estate tax standpoint, depending upon the size of the surviving spouse's estate and the exempt amount at the time of the spouse's death, it may be advantageous to fully fund the credit shelter trust, or otherwise take advantage of the entire estate tax exempt amount, so as to shelter the largest possible amount from being included in the surviving spouse's estate.

This situation will become more common as the estate tax exempt amount increases. The estate tax exempt amount is scheduled to increase to $1.5 million in 2004, $2 million in 2006, and $3.5 million in 2009. There is no estate tax in 2010. However, the estate tax returns in 2011, with a $1 million exempt amount.[31]

A participant can mandate the use of retirement benefits to the extent necessary to fully fund the credit shelter trust or estate tax exempt amount. The simplest way to do this is to leave the retirement benefits to the estate. However, an estate is not a designated beneficiary.[32] This means that, as a general rule, the benefits would have to be paid out over the participant's life expectancy as of just before his or her death if the participant had already reached his or her RBD,[33] or over five years if not.[34] One possible exception is that, if the marital share of the estate passes to the spouse outright rather than in a QTIP trust, the spouse may be able to roll over the portion of the retirement benefits necessary to satisfy the spouse's share, or perhaps the retirement benefits actually distributed to the spouse if the spouse is the executor,[35] although to accomplish this it may be necessary to obtain a private letter ruling.

Another way to fund the estate tax exempt amount is to create a separate trust, name that trust as the beneficiary of the retirement benefits, and then put the marital/credit shelter formula in that trust. From a drafting standpoint, this simplifies the beneficiary designation form, and may thus facilitate dealing with the plan administrator or IRA custodian. However, it requires drafting a separate trust, and coordinating the terms of the trust with the participant's Will.

Creating a separate trust with a marital/credit shelter formula also raises other issues. First, if the IRA benefits payable to the trust are subject to the estate's debts, administration expenses and estate taxes (presumably other than merely by operation of law), there is a question as to whether the estate is in effect the beneficiary of a portion of the benefits, so that there would be no designated beneficiary.[36] Second, even if the marital share passes outright, the rollover may not be available except to the extent that the marital share could not be satisfied with other assets, or at least to the extent that no one other than the spouse had any discretion to fund the marital share with other assets.[37] To accomplish such a rollover it may be necessary to obtain a private letter ruling. Third, there is an issue as to whether, if there is a pecuniary marital or a pecuniary credit shelter bequest, the use of retirement benefits to fund the pecuniary marital or pecuniary credit shelter bequest accelerates the income in respect of a decedent.[38] The last issue can be avoided by using a fractional share marital/credit shelter formula. However, a fractional share can be difficult to administer.

Another approach is to put the marital/credit shelter formula in the beneficiary designation form rather than in the Will or a separate trust agreement. The beneficiary designation would essentially provide that to the extent other assets are not sufficient to fully fund the credit shelter or exempt amount, the necessary portion of the retirement benefits would be payable to the credit shelter trust or other beneficiaries other than the spouse or the marital trust. This avoids all of the potential problems involved in leaving the retirement benefits to the estate or to a separate trust. Even if the use of retirement benefits to fund a pecuniary bequest accelerates the income in respect of a decedent, by placing the formula in the beneficiary description form, there is no pecuniary bequest, though to be safe one could use a fractional share formula in the beneficiary designation. Since the fractional share applies only to the particular retirement benefit, it should not cause the administrative complexities generally associated with a fractional share formula. However, it necessitates a complicated beneficiary designation, which may not be acceptable to the plan administrator or IRA custodian.

Often the most practical approach is to name the spouse as the primary beneficiary, and the credit shelter trust, or other beneficiaries, as the contingent beneficiaries. This approach allows the choice between

[30] §401(a)(9)(B)(iii); Regs. §1.401(a)(9)-3 A-3(b).

[31] §2010(c).

[32] Regs. §1.401(a)(9)-4 A-3.

[33] Regs. §1.401(a)(9)-5 A-5(a)(2).

[34] §401(a)(9)(B)(ii); Regs. §1.401(a)(9)-3 A-4(a)(2).

[35] E.g., PLRs 200151054, 200106047, 200032045; Bruce D. Steiner, "Postmortem Strategies to Shift Retirement Plan Assets to the Spouse," 24 *Estate Planning* 369 (1997).

[36] Marcia Chadwick Holt, "The 2001 Proposed Distribution Regulations," 36 *U. Miami Inst. on Estate Planning* ¶302.2B at 3-15 (2002); Natalie B. Choate, "Making Retirement Benefits Payable to Trusts," 34 *U. Miami Inst. on Estate Planning* ¶302 at 3-19 (2000); *see* PLR 9809059.

[37] PLRs 9633043, 9633042 and 9623056.

[38] §691(a)(2); Regs. §1.661(a)-2(f)(1); *Kenan v. Comr.*, 114 F.2d 217 (2d Cir. 1940); Marcia Chadwick Holt, "Retirement Planning: A Practical Guide to Making the Tough Choices," 29 *U. Miami Inst. on Estate Planning* ¶406.4 at 4-32 (1995).



ISSN 0886-3547

the income tax benefits of the spousal rollover and the potential estate tax benefits of fully funding the credit shelter trust or taking full advantage of the estate tax exempt amount to be postponed until the participant's death. However, the decision becomes the surviving spouse's, rather than the participant's. The spouse may choose not to disclaim even though his or her advisors recommend a disclaimer. Alternatively, the spouse's advisors may not be aware of the possibility of a disclaimer. The time period for a disclaimer (nine months from the participant's death, or nine months after the spouse reaches age 21, if later)[39] may elapse. The spouse may take the benefits before disclaiming, thus destroying his or her ability to disclaim them.[40] Finally, a disclaimer trust is less flexible than a mandatory credit shelter trust, since the spouse cannot have a power of appointment over a disclaimer trust, nor can the spouse participate in discretionary distributions to other beneficiaries (except as limited by an ascertainable standard).[41] Nevertheless, the benefits of being able to postpone the decision until the participant's death, thus preserving the opportunity for the spousal rollover, as well as the simplified drafting of the beneficiary designation, make this a desirable choice in many cases. In addition, this approach avoids all of the problems involved in leaving the retirement benefits to the estate or to a separate trust with a marital/credit shelter formula. Notwithstanding the benefits of this approach, some plan administrators or IRA custodians may not be comfortable with disclaimers.

Finally, several recent private letter rulings suggest that in a common law state (i.e., a noncommunity property state) it may be possible to utilize the same nonretirement assets to fund the credit shelter trust regardless of which spouse dies, if one spouse creates a revocable trust and gives the other spouse a general testamentary power of appointment over the trust assets if the other spouse dies first, or if both spouses create a joint revocable trust for their nonretirement assets.[42] If this works, the nonretirement assets will pass to the credit shelter trust regardless of which spouse dies first. Some commentators agree with this result.[43] Others disagree.[44] If this technique does not work, then the surviving spouse may be deemed to have made a taxable gift of his or her share of the revocable trust, or a portion of what was intended to be the credit shelter trust may be included in the surviving spouse's estate. For example, if each spouse has $1.5 million, and they each contribute their assets to a joint revocable trust, there is a risk that $2.25 million will be included in the surviving spouse's estate, assuming a $1.5 million exempt amount and no changes in the value of the assets, even though only $1.5 million would be included in the surviving spouse's estate if the couple had simply divided their assets and signed Wills containing marital deduction and credit shelter formula provisions. However, the risk is not the same in the case of retirement assets. For example, if a couple has $1 million of nonretirement assets which they contribute to a joint revocable trust, and one spouse has a $1 million IRA of which the other spouse is the beneficiary, and this technique does not work, the surviving spouse's estate will be $1.5 million (one-half of the nonretirement assets plus the IRA). However, if the couple divided their assets equally, the surviving spouse's estate would likewise be $1.5 million.

## CHILDREN'S TRUSTS

Perhaps the most common situation in which the use of a trust is indicated for retirement benefits is when the participant intends to benefit a child. As in the case of other assets, retirement benefits passing to a child in trust rather than outright can be kept out of the child's estate for estate tax purposes, and can be protected against the child's creditors (including spouses). The tradeoffs involving spousal rollovers or Roth conversions do not apply in the case of a child, since no beneficiary other than a spouse can roll the benefits over into his or her own IRA,[45] and hence no beneficiary other than a spouse can convert to a Roth IRA.

One frequently raised tradeoff is the higher income tax rates that are generally applicable to trusts.[46] However, a child's trust can provide the trustees with the flexibility to decide whether to distribute the income (including the retirement benefits for this purpose) to the child or to the child's issue, or to accumulate them in the trust, based upon all of the facts and circumstances existing from time to time, includ-

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[39] §2518(b)(2); Regs. §25.2518-2(c)(1).

[40] §2518(b)(3); Regs. §25.2518-2(d).

[41] §2518(b)(4); Regs. §25.2518-2(e)(2).

[42] PLRs 200210051, 200101021; *see also* TAM 9308002.

[43] Paul M. Fletcher, "Drafting Revocable Trusts to Facilitate a Stepped-Up Basis," 22 *Estate Planning* 100 (1995); Paul M. Fletcher, "A Practitioner's View of Tax Basis Revocable Trusts," *Trusts & Estates*, Jan. 1995, at 31; Richard A. Williams, "The Benefits and Pitfalls of Joint Revocable Trusts," *Trusts & Estates*, Nov. 1992, at 41.

[44] Michael Mulligan, "Income, Estate and Gift Tax Effects of Spousal Joint Trusts," 22 *Estate Planning* 195 (1995); Nancy E. Shurtz, "An Academic's View of Tax Basis Revocable Trusts," *Trusts & Estates*, Jan. 1995, at 43; Roy M. Adams and Thomas W. Abendroth, "The Joint Trust: Are You Saving Anything Other Than Paper," *Trusts & Estates*, Aug. 1992, at 39.

[45] §408(d)(3)(c).

[46] §1(e).



ISSN 0886-3547

ing the applicable income tax rates. In addition, it is often possible for trusts to avoid being subject to state income taxation.[47] Thus, to the extent income taxation is a factor, it weighs in favor of leaving retirement benefits to children in trust rather than outright.

A Roth IRA is a particularly valuable asset to which to allocate GST exemption, since the income and gains within the Roth IRA are income tax free. This is another reason for a Roth IRA owner to leave the Roth IRA benefits in trust rather than outright, particularly if he or she has available GST exemption. Since distributions from a Roth IRA are generally free of income tax the trust tax rates do not represent a tradeoff in the case of a Roth IRA.

To the extent the trust is not covered by the participant's or IRA owner's GST exemption and is therefore subject to GST tax, another possible tradeoff is that the GST tax is at the highest transfer tax rate, whereas assets passing to the beneficiary outright are subject to estate or gift tax (in the beneficiary's estate or if the beneficiary makes a gift) at graduated rates, and then only after the beneficiary uses his or her exempt amount. This tradeoff will become more important as the exempt amount increases. On the other hand, (i) in states that have decoupled, the estate tax rate may be higher than the GST tax rate, (ii) if the child appoints trust assets to or in trust for his or her grandchildren, the assets can pass down two generations at the cost of only one GST tax, whereas transfers of the child's own assets to or in trust for the child's grandchildren are subject to transfer taxes twice, (iii) the child can hedge against dying at a time when he or she has issue but does not have a taxable estate by buying life insurance, and (iv) it is always possible to distribute the trust assets to the child if desired. It may also be possible to give the child a general power of appointment over a portion of the trust by formula,[48] although it may not be desirable to do so.[49] It may also be possible to give the trustees the power to give the child a general power of appointment; however, giving the trustees this power may itself constitute a general power of appointment as a power exercisable with the consent of an independent trustee.[50] Of course, if the trust is the beneficiary of retirement benefits, giving the child (or giving the trustees the power to give the child) a general power of appointment is inconsistent with PLRs 200235038 through 200235041, and may result in the trust not having a designated beneficiary.

If each child is a contingent beneficiary of each of the other children's trusts, then each child's trust may be limited to a stretchout over the oldest child's life expectancy.[51] If the children are close in age, this is a relatively minor tradeoff. If not, then the younger children's trusts can be designed so that the older children are not contingent beneficiaries, at the cost of some loss of flexibility.

Another possibility is a conduit trust, in which all of the distributions from the IRA are in turn distributed to the child, so that each child will be treated as the sole beneficiary of his or her trust. However, if the child reaches his or her life expectancy, all of the trust assets will have been distributed to the child, thus defeating the transfer tax and asset protection benefits of the trust.

## GRANDCHILDREN'S TRUSTS

The considerations involved in leaving retirement benefits in trust for grandchildren are similar to those in the case of children, except that to the extent the benefits exceed the IRA owner's available GST exemption, GST tax is payable upon the IRA owner's death.

However, by leaving IRA benefits in trust for grandchildren (or outright to grandchildren), they can be stretched out over a longer period of time.

Assuming that contingent beneficiaries are taken into account in determining the oldest beneficiary of a trust, the children should not be contingent beneficiaries of the grandchildren's trusts if it is desired to stretch the benefits out over a grandchild's life expectancy.

## PAYING THE ESTATE TAX

In order to obtain the full benefit of the stretchout, a source of funds other than the retirement benefits must be available to pay the estate tax or the retirement benefits. This is particularly important where trusts are the beneficiaries, since trusts are less likely to have other assets with which to pay the estate tax.

Assuming a 50% estate tax rate, and disregarding the exempt amount, so long as the retirement benefits constitute less than one-half of the net estate, the non-retirement assets will be sufficient to pay the estate

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[47] *Mercantile Safe Deposit & Trust Co. v. Murphy,* 242 N.Y.S.2d 26 (3d Dept. 1963), *aff'd* 255 N.Y.S.2d 96 (1964); N.Y. Regs. §105.23; *Pennoyer v. Director,* 5 N.J. Tax 386 (1983), *Potter v. Director,* 5 N.J. Tax 399 (1983); Max Gutierrez, Jr., "The State Income Taxation of Multi-Jurisdictional Trusts," 36 *U. Miami Inst. on Estate Planning* §13 (2002).

[48] PLR 9527024.

[49] Richard B. Covey, "Question and Answer Session I of the Thirty-Second Annual Institute on Estate Planning," 32 *U. Miami Inst. on Estate Planning* ¶215 at 2-25 – 2-26 (1998).

[50] Dave L. Cornfeld, "Question and Answer Session I of the Thirty-Second Annual Institute on Estate Planning," 32 *U. Miami Inst. on Estate Planning* ¶215 at 2-26 (1998).

[51] PLRs 200235038 through 200235041.



ISSN 0886-3547

taxes on the entire estate. However, if the retirement benefits constitute more than one-half of the net estate, the nonretirement assets may not be sufficient to pay the estate taxes or the entire estate. This problem can be exacerbated by converting to a Roth IRA and using nonretirement assets to pay the income tax on the conversion.

If the participant or IRA owner is living, he or she should consider making lifetime gifts to or in trust for his or her beneficiaries, so as to reduce the estate taxes and increase the amount of assets not subject to estate tax.

After the participant's or IRA owner's death, the beneficiaries of the retirement benefits will have to provide the funds to pay the estate tax to the extent the nonretirement assets are not sufficient, or to the extent the taxes are charged against the recipients of the retirement benefits.

If a trust is a beneficiary of retirement benefits, it may be able to receive funds by means of a distribution from another trust, such as an insurance trust.[52] If such a distribution is contemplated, care must be taken to avoid violating the rule against perpetuities, as well as to avoid any adverse GST tax consequences. Assuming it will not significantly reduce the available perpetuities period or result in any adverse GST tax consequences, a simple approach is to have the retirement benefits payable to an insurance trust, so that the insurance proceeds can be used to pay the estate tax.

Another possibility is for the trust to borrow money from the beneficiaries of the trusts. While though the interest will not be deductible for income tax purposes, the retirement benefits enjoy favorable income tax treatment. The trusts can then repay the loan as the retirement benefits are received.

Alternatively, the estate can borrow the money to pay the estate taxes, to be repaid as the trusts receive the retirement benefits and reimburse the estate for the estate taxes. It is not clear whether the estate can deduct the interest for estate tax purposes.

## CONCLUSION

While the rules governing trusts as beneficiaries of retirement benefits are difficult and uncertain, leaving retirement benefits in trust rather than outright often provides estate planning, transfer tax and asset protection benefits.

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[52] NY EPTL §10-6.6; Alaska Statutes §13.36.157; *Matter of Spencer,* 232 N.W.2d 491 (Iowa 1975); *Phipps v. Palm Beach Trust Co.,* 142 Fla. 782, 196 So. 299 (1940); *see Matter of Wold,* 310 N.J. Super. 382 (Ch. Div. Middlesex Co. 1998); *National State Bank of Newark v. Morrison,* 9 N.J. Super. 552 (Ch. Div. 1950); *Guild v. Mayor,* 87 N.J. Eq. 38 (1916).




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# TRUSTS AS BENEFICIARIES OF RETIREMENT BENEFITS

## Rockland County Estate Planning Council

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Mr. Steiner has lectured for the American Bar Association, the New York State Bar Association, the New York City Bar Association, the New Jersey Institute for Continuing Legal Education, BNA Tax Management, the Rockland, Essex and Middlesex County Bar Associations, the New York and New Jersey State CPA Societies, the New York City, the Rockland County, the Hudson Valley, the Western Connecticut, the Northern New Jersey, the Middlesex-Somerset, the Central New Jersey, and the Greater New Jersey Estate Planning Councils, the Financial Planning Association, the New York University and Baruch College Schools of Continuing Education, the C.W. Post Tax Institute, the Farleigh Dickinson Tax Institute, the New York City, the Greater Newark and the Fairfield County CLU Chapters, JP Morgan Chase Bank, Bank of America, Wells Fargo Bank, Hudson Valley Bank, Merrill Lynch, Metropolitan Life, Cornell University, Consumers Union, Lawline, the Committee of Banking Institutions on Taxation and many other professional and community groups across the country.

Mr. Steiner has written articles for *Estate Planning*, *BNA Tax Management*, *Trusts & Estates*, the *Journal of Taxation*, the *CPA Journal*, *Probate & Property*, *TAXES*, the *Journal of Corporate Taxation*, the *CLU Journal*, and other professional journals.

Mr. Steiner is a commentator for Leimberg Information Services, Inc., a technical advisor for *Ed Slott's IRA Advisor*, and a member of the editorial advisory board of *Trusts & Estates*. For many years he wrote a column for the CCH Journal of Retirement Planning, and was a deputy editor of the *Bergen Barrister*. He has served as a director of the Estate Planning Council of New York City, and on the professional advisory boards of several major charitable organizations.

Mr. Steiner has been quoted in various publications including *Forbes*, the *New York Times*, the *Wall Street Journal*, *USA Today*, the *Daily Tax Report*, *Investment News, Lawyers Weekly, Bloomberg's Wealth Manager, Financial Planning, Kiplinger's Retirement Report, Medical Economics, Newsday*, the *New York Post*, the *Naples Daily News*, *Individual Investor*, TheStreet.com, and Dow Jones (formerly CBS) Market Watch. He was named a New York Super Lawyer in 2010, 2011, 2012, 2013, 2014 and 2015.

Mr. Steiner received an A.B. from Cornell University, a J.D. from the State University of New York at Buffalo, and an LL.M. in taxation from New York University, where he was a Gerald L. Wallace scholar.

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**Rockland County Estate Planning Council**

**May 13, 2016**

## I. Why Place Retirement Benefits in Trust or Choose Trusts as Beneficiaries of Retirement Plan Benefits.

A. The same reasons for giving or leaving other assets in trust apply to retirement benefits.

1. To separate the control from the beneficial ownership.

2. To protect beneficiaries from undue taxation and claims by spouses (both current and future), unmarried, partners and creditors.

3. In most states, including New York, trust assets are not protected against claims by the grantor's creditors. However, trust assets and benefits payable to the trust are generally protected against claims by the beneficiaries' creditors.

4. To protect a spendthrift beneficiary (*i.e.*, one who may accrue excessive debts).

5. To provide for a beneficiary with special needs without jeopardizing government benefits.

6. To provide for a spouse in the form of a QTIP trust.

7. To fully fund a credit shelter trust.

8. To fund a GST exempt trust.

9. Income tax flexibility.

10. To keep the assets out of the beneficiary's estate for estate tax purposes (except in the case of a QTIP trust).

11. See Bruce D. Steiner, "Trusts as Beneficiaries of Retirement Benefits," 29 *Tax Management Estates, Gifts and Trusts Journal* 108 (2004): http://www.kkwc.com/docs/AR20041209132954.pdf; http://www.elderlawanswers.com/Documents/Trusts%20as%20Beneficiaries%20of%20Retirement%20Benefits.pdf.

B. The recent Supreme Court decision in *Clark v. Rameker*, 573 U.S. ___, 134 S.Ct. 2242 (2014), https://scholar.google.com/scholar_case?case=6536441922745620892&q=clark+v.+rameker&hl=en&as_sdt=3,31, illustrates the asset protection benefits of leaving assets in trust.

1. In *Clark v. Rameker*, the Supreme Court held that an inherited IRA for a non-spousal beneficiary was not protected under the Federal exemptions of the bankruptcy law.

2. Whether inherited IRAs are protected in bankruptcy by state law exemptions, or whether inherited IRAs are protected against creditors outside of bankruptcy, varies from state to state.

3. Beneficiaries can move to different states, and states can change their laws.

4. By designating a trust for an individual rather than the individual as a beneficiary for specified assets, the assets may be excluded from the bankruptcy estate and thereby protected against the individual's creditors.

5. It is not yet certain if *Clark v. Rameker* will be extended to spousal beneficiaries. The courts may make an exception for a spouse since a spouse may perform a rollover and therefore the points that were used to distinguish inherited IRAs from contributory IRAs don't apply.

6. This applies to IRA benefits as well as to other assets.

C. Tax law creates some complexity.

1. In general, the oldest beneficiary of the trust is considered the designated beneficiary for purposes of determining the required distributions from tax-qualified plans and IRAs.

2. In order to be able to pay out benefits very slowly and thereby defer taxes on retirement benefits, none of the trust's retirement benefit payments may go to anyone other than an individual.

D. Some people without any close relatives may not have a suitable co-trustee. However, if they take outright, query who will assist them with their financial affairs when they are no longer able to handle those affairs.

## II. **<u>Trusts for Children or Grandchildren.</u>**

A. Trusts for children:

1. The trustees may be given discretion to distribute the income and principal of the trust to or for the benefit of the child and the child's issue.

2. The child may have both a lifetime and a testamentary special power of appointment over the income and principal of the trust.

3. The power may be limited to the child's issue, or the client's issue (other than the child or the child's estate or creditors).

4. The child may have the broadest possible special power, exercisable during lifetime after a specified age, or by Will.

5. Upon reaching a specified age, the child may be a trustee.

6. Upon reaching a specified age, the child may be given the power to remove and replace his or her co-trustee. *Vak v. Commissioner,* 973 F.2d 1409 (8th Cir. 1992), *rev'g* T.C. Memo 1991-503; *Estate of Helen S. Wall*, 101 T.C. 300 (1993); Rev. Rul. 95-58, 1995-2 Cum. Bull. 191. The replacement trustee may have to be someone not related or subordinate. *But see* PLR 199909016.

B. Trusts for grandchildren:

1. By naming grandchildren (or trusts for their benefits) as beneficiaries, the benefits may be stretched out over the grandchildren's life expectancies after the participant's death.

2. This provides substantial income tax deferral, especially in the case of a Roth IRA.

## III. Federal Income Taxation of Trusts and Beneficiaries.

A. Income is generally taxable to the beneficiaries to the extent the beneficiaries receive distributions, and to the trust to the extent the income is not distributed.

B. There may be some income tax cost to accumulating income in a trust.

1. The top 39.6% Federal income tax bracket on ordinary income and the 20% Federal tax rate on qualified dividends and long-term capital gains applies to trusts for taxable income in excess of $12,300 of taxable income but not to individuals until their taxable income exceeds $413,200 (single) or $464,850 (joint).

2. Trusts pay the 3.8% net investment income tax on income above $12,300, whereas individuals pay this tax above $200,000 (single) or $250,000 (joint).

C. If the creator of the IRA (known as the IRA owner) converts a traditional IRA to a Roth IRA during lifetime, this will avoid the compressed income tax brackets for trusts that are IRA beneficiaries.

1. Distributions from a Roth IRA are generally exempt from income tax (though a Roth IRA, like a traditional IRA, is subject to tax on its unrelated business taxable income).

2. Distributions from a Roth IRA to a trust retain their character as tax-free Roth IRA benefits. Thus, they are not included in the trust's distributable net income (DNI).

3. Therefore, distributions of Roth IRA benefits in excess of the trust's DNI are not taxable to the beneficiaries of the trust.

D. The trustees may consider the beneficiaries' income tax brackets in deciding upon discretionary distributions.

E. However, amounts distributed are thrown into the beneficiaries' estates, and are exposed to the beneficiaries' creditors and spouses.

## IV. State Income Taxation of Trusts.

A. State income taxation may be important when a trust is the beneficiary of an IRA.

1. Ignoring any basis, distributions to a trust from a traditional IRA are subject to income tax.

2. State income tax rates can be as high as 13.3% in California, or 12.696% in New York City (8.82% New York State plus 3.876% New York City).

B. A resident trust is taxable on all of its income. However, a nonresident trust is only taxable on income sourced in the state.

C. Different states have different ways of determining whether a trust is a resident trust.

D. Whether a trust is a resident trust for income tax purposes is generally independent of the governing law set forth in the trust.

E. Some states, such as New York or New Jersey, determine the residence of a trust based upon the residence of the grantor or decedent.

F. Some states, such as Arizona and Kentucky, determine the residence of a trust based upon where the trust is administered.

G. Some states, such as Colorado and Maryland, determine the residence of a trust based upon where the trust is administered.

H. Some resident trusts are exempt from state income taxation.

1. New York exempts resident trusts from state income taxation where there are no trustees or assets in New York and no New York source income. Tax Law § 605(b)(3)(D); *Mercantile Safe Deposit & Trust Co. v. Murphy,* 242 N.Y.S.2d 26 (3d Dept. 1963), *aff'd.,* 255 N.Y.S.2d 96 (1964); Reg. § 105.23.

2. New Jersey exempts resident trusts from state income taxation where there are no trustees, beneficiaries or assets in New Jersey and no New Jersey source income. *Pennoyer v. Director, Division of Taxation*, 5 N.J. Tax 399 (1983) (testamentary trusts), and *Potter v. Director*, *Division of Taxation*, 5 N.J. Tax 399 (1983) (inter vivos trusts). However, the instructions to the New Jersey fiduciary income tax return (Form NJ-1041) do not require the absence of a New Jersey beneficiary to avoid being subject to New Jersey income tax. It is not clear what a "beneficiary" is for this purpose.

3. In some states, if there is no ongoing connection with the state, a resident testamentary trust is taxable, but a resident trust created during lifetime is not taxable.

(a) Illinois: *Linn v. Department of Revenue*, No. 4-12-2055 (Appellate Court of Illinois, 4th District, December 18, 2013).

(b) Pennsylvania: *McNeil Trust v. Commonwealth of Pennsylvania*, 67 A.3d 185, Nos. 651 F.R. 2010, 173 F.R. 2011 (Commonwealth Court of Pennsylvania May 24, 2013.

I. New York now has a throwback rule for amounts accumulated in an exempt resident trust in one year and distributed to a New York resident beneficiary in a subsequent year.

## V. <u>Minimum Distribution Requirements for a Trust that is the Beneficiary of a Retirement Plan or IRA.</u>

A. Under Treas. Reg. § 1.401(a)(9)-4 Q&A 5 and 6, if a trust is named as beneficiary, the beneficiaries of the trust are treated as designated beneficiaries if the following requirements are met:

1. The trust is a valid trust under state law, or would be but for the fact that there is no corpus.

2. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee.

3. The beneficiaries of the trust are identifiable from the trust instrument.

4. If the participant reaches the date his or benefit payments must begin, and wants to have the spouse treated as the sole beneficiary he or she must either:

(a) Provide the plan administrator a copy of the trust instrument and agree that, if it is amended, he or she will, within a reasonable time, provide the plan administrator a copy of each such amendment; or

(b) Provide the plan administrator a list of all the beneficiaries of the trust (including contingent and remainder beneficiaries within a description of the conditions on their entitlement; certify that, to the best of his or her knowledge, the list is correct and complete and that the other requirements (valid trust, irrevocable and identifiable beneficiaries) are met; agree to provide corrected certifications to the extent an amendment changes any information; and agree to provide a copy of the trust instrument on demand.

5. For required distributions after death, by October 31 of the calendar year following the participant's death, the trustee must either:

   (a) Provide the plan administrator with a final list of all the beneficiaries (including contingent and remainder beneficiaries with a description of the conditions on their entitlement); certify that, to the best of his or her knowledge, the list is correct and complete and that the other requirements are met; and agree to provide a copy of the trust instrument on demand; or

   (b) Provide the plan administrator with a copy of the actual trust document.

## VI. <u>The Stretch is Limited to the Life Expectancy of the Oldest Beneficiary.</u>

A. If there is more than one beneficiary, the life expectancy of the oldest beneficiary is used in determining the payout period. Section 401(a)(9)(B)(iv)(I); Treas. Reg. § 1.401(a)(9)-5 A-7.

B. The beneficiaries of the trust must be individuals. Treas. Reg. § 1.401(a)(9)-4 Q&A 5.

C. The remainder beneficiaries must be considered. Treas. Reg. § 1.401(a)(9)-5 A-7(c)(1) and A-7(c)(3) Example 1; Rev. Rul. 2000-2, 2000-1 Cum. Bull. 305.

D. If a charity is a remainder beneficiary, the requirement that all of the beneficiaries be individuals is not satisfied. PLRs 9846034 and 9820021; *see* Steven E. Trytten, "Tax and Investment Planning for the Individual: Roth IRAs and Other Retirement Assets," 57 N.Y.U. Institute on Fed. Taxation § 24.03[3][a] (1999).

E. A contingent beneficiary is generally considered a beneficiary. Treas. Reg. § 1.401(a)(9)-5 A-7(b).

F. A "mere successor beneficiary" is not considered a beneficiary. However, a person who has any right (including a contingent right) beyond being a mere successor beneficiary is considered a beneficiary.

G. Thus, if one person has a right to all income for life, and a second person has a right to principal (including the principal distributed during the first beneficiary's lifetime), both are considered beneficiaries. Treas. Reg. 1.401(a)(9)-5 A-7(c).

H. In PLR 201203003, the Service ruled that the existence of a remainder beneficiary who would take outright in default of exercise of a power of appointment acted as a blocker, so that a charity that was a contingent default remainder beneficiary was disregarded. Bruce D. Steiner, "Post-Mortem Action Can Limit Class of Beneficiaries," 151 Trusts & Estates No. 5, 13 (May 2012).

I. Remote contingent beneficiaries were considered beneficiaries in PLR 200228025, but not in previous rulings (*e.g.*, PLR 20004035).

1. In PLR 200228025, the IRA went to separate trusts for the benefits of the grandchildren.

2. If both grandchildren died before age 30, the balance of the trust went to contingent beneficiaries, the oldest of whom was age 67.

3. The 67-year-old was considered a beneficiary, even though her interest was extremely remote.

J. It has been argued that a remote contingent beneficiary should be disregarded if there is less than a 5% probability that the trust would pay out to him or her. Martin Silfen, quoted in David W. Polstra, "Accumulation Trusts as Beneficiaries of IRAs — A Fateful Twist for the Unwary," *CCH J. of Retirement Planning*, Mar. 2003, at 35, 39.

K. Remote contingent takers by operation of law are arguably disregarded.

1. If not, it would be virtually impossible for any trust to qualify.

2. The regulations provide that "the fact that an employee's interest under the plan passes to a certain individual under a will or otherwise under application of state laws does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan." Treas. Reg. § 1.401(a)(9)-4 A-1.

L. Are permissible appointees considered beneficiaries? In PLRs 200235038 through 200235041, the powers of appointment could not be exercised in favor of anyone older than the desired designated beneficiary, and the trustees were not permitted to distribute the trust assets to another trust in which anyone older than the desired beneficiary could be a beneficiary or a permissible appointee.

M. In PLR 200320021, the IRS disregarded the persons who would receive the balance of the trust if the trust ran out of beneficiaries.

N. Several rulings have allowed a large class of permissible appointees, and have disregarded both intestate takers and the possibility of escheat. PLRs 201203033, 200537044, 200235038 through 2002350-41.

O. In PLR 201203033, the Service allowed the holder of a power of appointment to release the power to the extent it permitted him or her to appoint in favor of anyone older than the desired oldest beneficiary, or anyone other than a natural person.

P. There is an exception for a conduit trust. Treas. Reg. § 1.401(a)(9)-5 A-7(3) Example 2.

1. In a conduit trust, the trustees must distribute the MRDs (and any optional distributions in excess of the MRDs) to the beneficiaries on a current basis.

2. Thus, no amounts distributed may be accumulated for subsequent beneficiaries.

3. The subsequent beneficiaries are disregarded.

4. However, conduit trusts rarely make sense.

(a) Except where the spouse is the beneficiary, if the beneficiary lives to life expectancy, nothing will be left in the trust.

(b) Except where the spouse is the beneficiary, all of the IRA benefits will have been distributed to the beneficiary, and will be included in the beneficiary's estate, and exposed to the beneficiary's creditors and spouses.

5. In particular, conduit trusts are unlikely to make sense for a beneficiary with special needs.

Q. In PLR 200537004, the Service allowed a trust protector (someone with specified powers over a trust) to convert a conduit trust into a discretionary trust pursuant to the terms of the trust instrument.

1. The Service considered this a disclaimer by the protector. But query whether it was the exercise of a power of appointment or a decanting rather than a disclaimer.

2. The conversion limited the permissible appointees under the beneficiary's power of appointment and the takers in default of exercise of the beneficiary's power to appointment to persons not older than the beneficiary.

3. Treas. Reg. § 1.401(a)(9) allows beneficiaries eliminated by September 30 of the year following the date of death to be disregarded.

4. The IRA owner could have avoided the complexity and the need for a ruling by simply leaving the IRA to a discretionary trust in the first place.

## VII. The Marital (QTIP) Trust as Beneficiary.

A. The estate tax marital deduction is available for benefits payable either to the spouse or to a QTIP trust.

B. The seminal authority for naming a QTIP trust as beneficiary is Rev. Rul. 89-89, 1989-2 Cum. Bull. 231. Rev. Rul. was superseded by Rev. Rul. 2000-2, 2000-1 Cum. Bull. 305, which was modified by Rev. Rul. 2006-26.

C. The Service treats the IRA itself as the QTIP property.

D. In the case of qualified plan benefits, the trustees of the QTIP trust may transfer the qualified plan benefits to an inherited IRA.

E. Basic characteristics of a QTIP trust.

1. The spouse must be entitled to all of the income of the trust.

2. The trustees may be given discretion to distribute principal to the spouse.

3. The spouse may have a testamentary special power of appointment over the principal of the trust.

4. The spouse may be a trustee.

5. The spouse may be given the power to remove and replace his or her co-trustee.

F. Distribution rules applicable to a QTIP trust.

1. Both the QTIP and the required distribution (RMD) rules must be satisfied.

2. The trustees of the QTIP trust must take distributions from the IRA over the spouse's life expectancy.

3. The trustees must take additional distributions to the extent the income exceeds the RMD.

4. The trustees may take distributions in excess of the amounts required.

5. Over the course of the spouse's life expectancy, the IRA will be paid to the QTIP trust.

   (a) The spouse need only be entitled to receive the income.

   (b) The principal may be accumulated in the trust.

6. The internal income of the IRA may exceed the RMD if the spouse is relatively young.

7. If the internal income of the IRA exceeds the RMD, the spouse may be able to roll the excess over into his or her own IRA. *See* PLRs 200543064 and 9649045. *But see* PLR 9145041.

8. The Service takes the position that the spouse must be entitled to receive all of the income from the IRA as well as from the QTIP trust.

9. It may be argued that the IRA should not have to distribute its income so long as the QTIP trust has other assets that may ben used to make compensating distributions to the spouse.

   (a) This is consistent with Treas. Reg. §§ 20-2056(b)-5(f)(5) and -7(d)(2), which allow the spouse's beneficial enjoyment to be satisfied in the case of non-income producing assets if the spouse may require payments out of other assets of the trust.

   (b) However, it is not consistent with Rev. Rul. 2006-26, Rev. Rul. 2000-2 or Rev. Rul. 89-89.

10. In a conduit QTIP trust, all of the RMDs (or any optional distributions in excess of the RMDs) must be paid to the spouse, even if they exceed the income.

   (a) Since none of the RMDs (or any optional distributions in excess of the RMDs) may be accumulated, the remainder beneficiaries are disregarded, so the spouse is treated as the sole beneficiary. Treas. Reg. § 1.401(a)(9)-5 A-7 Example 2.

   (b) Thus, no RMDs are required until the year the participant or IRA owner would have reached age 70

½. Section 401(a)(9)(B)(iii); Treas. Reg. § 1.401(a)(9)-3 A-3(b).

(c) The spouse's life expectancy is recalculated annually. This results in smaller RMDs. Treas. Reg. § 1.401(a)(9)-5 A-5(c)(2).

(d) Note that if the MRDs exceed the internal income of the IRA, the principal portion of the MRDs must be paid to the spouse. Thus, the conduit QTIP trust will not have any assets (other than being a beneficiary of the IRA) until the spouse's death.

(e) The advantage of the conduit QTIP trust is that the spouse is treated as the sole beneficiary (except for rollover purposes). Thus, the required distributions are smaller than in the conventional QTIP trust.

(f) However, the conduit QTIP trust gives the spouse control over more assets than the conventional QTIP trust.

G. There is a substantial income tax cost to leaving IRA benefits to a QTIP trust instead of to the spouse.

1. A spouse may roll the benefits over into his or her own IRA, thereby obtaining substantial additional income tax deferral during his or her lifetime. Sections 402(c)(9) and 408(d)(3)(c)(ii)(II).

2. The spouse may name new beneficiaries, thereby obtaining substantial additional income tax deferral after the spouse's death.

3. If the spouse lives long enough, and determines that the children do not need the IRA benefits, the spouse may change the beneficiaries to the grandchildren (or trusts for the grandchildren), thus obtaining additional income tax deferral after the spouse's death.

4. The spouse may be able to convert to a Roth IRA. Section 408A(c)(3)(B).

5. If the spouse is under age 59 ½, the spouse may keep the IRA in the decedent's name, with the spouse as beneficiary.

(a) This avoids the penalty on distributions before age 59 ½.

(b) A spouse who is a beneficiary of qualified plan benefits may roll them over into an IRA in the decedent's name, with the spouse as beneficiary. PLR 200450057.

H. With a $5,430,000 (indexed) Federal estate tax exclusion amount, and portability, very few IRA owners will name a QTIP trust as beneficiary.

I. Non-tax reasons for leaving IRA benefits to a QTIP trust.

1. Where there are children from a previous marriage, and the retirement benefits are a large portion of the estate, the IRA owner may want to ensure that the remainder interest after the spouse's death goes to those children.

2. Where the spouse is a spendthrift; *i.e*. spends too much money, a QTIP trust protects against the spouse dissipating the IRA assets.

3. Where the spouse will require substantial distributions during his or her lifetime, so that it will not be possible to take advantage of the entire income tax benefit of leaving the IRA to the spouse.

4. In New Jersey, dispositions to a QTIP trust receive 50% credit toward the elective share.

J. If an IRA owner leaves his or her IRA benefits to a QTIP trust, the executors may decide whether and to what extent to elect QTIP.

K. An IRA owner may provide for a *Clayton* QTIP trust.

1. In a *Clayton* QTIP trust, to the extent the executors do not elect QTIP, the property instead goes to the credit shelter trust. *Estate of Spencer v. Commissioner,* 43 F.3d 226 (6th Cir. 1995), *rev'g.* T.C. Memo 1992-579; *Robertson v. Commissioner,* 15 F.3d 779 (8th Cir. 1994), *rev'g.* 98 T.C. 678 (1992); *Estate of Clayton v. Commissioner*, 976 F.2d 1486 (5th Cir. 1992), *rev'g*. 97 T.C. 327 (1991); *Estate of Willis E. Clack,* 106 T.C. 131 (1996), *acq.*, 1996-2 Cum. Bull. 1.

2. This allows the executors to decide whether to make a full or partial QTIP election based upon the facts and circumstances at the time of the decedent's death.

3. The primary advantage of the *Clayton* QTIP provision is that, to the extent the QTIP election is not made, the income from the non-QTIP portion need not be paid to the spouse.

4. If you use the *Clayton* QTIP, you give up the opportunity for the credit for the estate tax on prior transfers in the surviving spouse's estate by making a partial QTIP election, if the spouse dies within 10 years.

## VIII. **<u>Special Considerations for QTIP Trusts for Noncitizen Spouses.</u>**

A. In order to qualify for the marital deduction, assets passing to a noncitizen spouse must be in the form of a qualified domestic trust ("QDOT").

B. The final QDOT regulations permit the spouse to create the QDOT after the participant's death.

C. Treas. Reg. § 20.2056A-4(c) allows the surviving spouse to agree to contribute to a QDOT the principal portion of each annuity payment under a non-assignable annuity.

1. The regulation provides that the spouse's interest as beneficiary of an IRA is eligible for this procedure, and that the Service will prescribe by administrative guidance the extent, if any, to which these procedures apply to a rollover from a qualified plan to an IRA.

2. However, the Service has not yet issued such guidance.

D. In PLR 9623063, the Service allowed the surviving spouse to roll the deceased spouse's IRAs over into a trusteed IRAs subject to a QDOT agreement.

E. In PLR 9746049, the spouse was the beneficiary of an IRA. The Service allowed the spouse to agree to contribute the principal portion of each IRA distribution to a QDOT.

F. In PLR 9746049, the Service also allowed the income and principal to be determined as if the IRA were a trust.

G. The QDOT regulations generally respect a power to adjust or a unitrust for QDOT purposes if it is permitted by state law. Treas. Reg. § 20.2056A-5(b)(2).

## IX. **<u>The Credit Shelter Trust as Beneficiary.</u>**

A. With the increase in the Federal estate tax exclusion amount to $5,430,000 (indexed), and portability having been made permanent, fewer decedents are subject to estate tax, and thus fewer clients need a credit shelter trust to avoid Federal estate tax.

B. This situation is also more common due to Roth conversions, since the income tax on the conversion reduces the size of the estate.

C. Compared to other assets, retirement benefits payable to a credit shelter trust provide some income tax deferral, but (except in the case of a Roth IRA) represent pre-tax money.

D. Sometimes clients who may find credit shelter trusts useful lack sufficient other assets to fully fund the credit shelter trust.

E. There is a tradeoff between the income tax advantage of the spousal rollover and to potential estate tax benefit of fully funding the credit shelter trust.

F. This may be done by a formula, whereby the credit shelter trust is the beneficiary of the portion of the retirement benefits necessary to fully fund the credit shelter trust, after taking into account any nonretirement assets.

   1. This requires the use of a marital/credit shelter formula in the beneficiary designation.

   2. Some plan administrators or IRA custodians or trustees may balk at a beneficiary designation containing such a formula.

G. Alternatively, the participant or IRA owner may put the marital/credit shelter formula in a separate trust under the Will or in a separate trust agreement.

   1. This may make it easier to deal with the IRA custodian or trustee.

   2. However, this risks accelerating the income in respect of a decedent upon the funding of a pecuniary marital or credit shelter bequest with retirement assets. Section 691(a)(2); *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940); CCM 200644020 (funding pecuniary bequest with an IRA accelerates the income); Marcia Chadwick Holt, "Retirement Planning: A Practical Guide to Making the Tough Choices," 29 U. Miami Institute on Estate Planning ¶ 406.4 (1995); Louis A. Mezzullo, "Planning for Distributions from Qualified Retirement Plans and IRAs," 27 U. Miami Institute on Estate Planning § 704.1 (1993).

   3. This may also jeopardize the spouse's ability to roll over the marital share payable to him or her through the trust. *See* Bruce D. Steiner, "Postmortem Strategies to Shift Retirement Plan Assets to the Spouse," 24 *Estate Planning* 369 (1997).

   4. This requires creating a separate trust, and coordinating the terms of the trust with the Wills.

H. The income tax benefits of leaving retirement benefits to the spouse may outweigh the estate tax advantages of fully funding the estate tax exempt amount.

I. In decoupled states such as New York and New Jersey, fully funding the credit shelter trust with $5,430,000 costs $502,727 in state estate tax.

J. The New York estate tax exclusion amount is scheduled to be equal to the Federal estate tax exclusion amount beginning in 2019.

K. The New Jersey estate tax exclusion amount is still $675,000.

L. Now that portability has been made permanent, the tradeoff between the income tax benefits of leaving the IRA to the spouse and the estate tax benefits of fully funding the credit shelter amount is less important.

M. Portability only applies to the Federal estate tax. It does not apply to the GST tax, or to the New York or New Jersey estate tax.

N. Thus, participants and IRA owners may want to name the spouse as primary beneficiary, with a QTIP trust, *Clayton* QTIP, or credit shelter trust, as contingent beneficiary.

1. This simplifies the beneficiary designation.

2. This defers the decision until after the participant's death.

3. The spouse may choose not to disclaim.

4. While the spouse may have a power of appointment over a mandatory credit shelter trust, the spouse may not have a power of appointment (or participate as a trustee in discretionary distributions) over the disclaimed property, except as limited by an ascertainable standard such as health maintenance, support and education. Treas. Reg. § 25.2518-2(e)(2).

5. You may postpone the decision by naming the spouse as primary beneficiary and the credit shelter trust as contingent beneficiary.

6. The spouse may then decide whether to accept all of the IRA benefits, or whether to disclaim the portion of the IRA benefits necessary to fully fund the credit shelter trust.

7. Note that a disclaimer trust is less flexible then a mandatory credit shelter trust.

(a) The spouse may not have a power of appointment over a disclaimer trust.

(b) The spouse may not participate in discretionary distributions to other beneficiaries, except as limited by an ascertainable standard.

8. Note that the spouse might not disclaim even if it makes sense from a tax standpoint for him or her to disclaim.

O. To avoid accelerating the income in respect of a decedent, consider leaving a fractional share of the retirement benefits to the spouse or QTIP trust and a fractional share to the credit shelter trust.

P. As the estate tax exclusion amount increases, the flexibility of the credit shelter trust and the extent of the spouse's control over the credit shelter trust become more important.

Q. The trustees may be given discretion to distribute the income and principal of the trust to or for the benefit of the spouse and issue, or only the spouse.

R. The spouse may have both a lifetime and a testamentary power of appointment over the income and principal of the trust.

1. The permissible appointees may be limited to issue, or to issue and their spouses.

2. The power may be further limited so that an equal share must go to or for the benefit of each child or that child's issue.

3. The spouse may have the broadest possible special power, exercisable in favor of anyone but the spouse, his or her estate, his or her creditors or the creditors of his or her estate.

S. The spouse may be a trustee.

T. The spouse may be given the power to remove and replace his or her co-trustee. The replacement trustee may have to be someone not related or subordinate. Rev. Rul. 95-58, 1895-2 Cum. Bull. 191. *But see* PLR 199909016.

U. You may limit the credit shelter to the state exempt amount, and let the surviving spouse decide whether to disclaim all or part of the marital share.

1. The spouse may choose not to disclaim.

2. Disclaimer trusts are less flexible.

3. The spouse may not have any power to direct the beneficial enjoyment of the disclaimed property, except as limited by an

ascertainable standard. Sections 2518(b)(4); Treas. Reg. § 25.2518-2(e)(2).

4. The spouse may disclaim the power to make discretionary distributions and still remain as a trustee. PLR 9245011.

5. The surviving spouse must disclaim, if at all, within nine months after the first spouse's death (or nine months after the surviving spouse reaches age 21, if later), and before accepting the disclaimed property or any benefits from it. Section 2518(b).

V. If the terms of a trust are not as desired, it may be possible to amend or decant the trust.

## X. <u>Transfer of an IRA or Other Retirement Assets to a Trust.</u>

A. There is no authority permitting an IRA owner to transfer an IRA or an interest in an IRA to a trust. However, in PLR 201150037, the Service allowed an IRA owner who acquired the IRA in a divorce to place "directions" on the IRA custodian that limited the IRA owner's access to the IRA without it resulting in any adverse tax consequences.

1. Distributions in excess of the required distributions could not be made until 30 days after the IRA owner's request.

2. The custodian had to notify the IRA owner's attorney of any such requests.

3. The IRA owner could change her directions upon 30 days' notice. However, the custodian had to notify the IRA owner's attorney of any change in her directions.

B. In PLR 200620025, the Service allowed a beneficiary to "transfer" the beneficiary's share of an inherited IRA to a grantor trust without any adverse tax consequences.

1. The trust was a special needs trust.

2. The Service ruled that the transfer of the inherited IRA to the trust was not a taxable transfer, and that no taxable income would be recognized upon the transfer.

3. The Service also ruled that the required distributions would be based upon the beneficiary's life expectancy.

C. However, in PLR 201117042, an IRA owner was not permitted to transfer the IRA to a special needs trust.

## XI. Amending, Decanting or Changing an Irrevocable Trust.

A. If the terms of a trust are not as desired, it may be possible to amend or decant the trust.

B. The holder of a power of appointment may exercise it.

C. If the trustees have full discretion to distribute principal (*i.e.,* not limited by an ascertainable standard), it may be possible to decant the existing trust into a new trust, which will run for the lifetime of the remainder beneficiaries.

D. Decanting is transferring some or all of the assets of a trust to another trust.

E. Decanting may be used to eliminate unwanted beneficiaries.

F. New York was the first state to enact a decanting statute. It was amended in 2001 in an attempt to conform to Treas. Reg. § 26.2601(b)(4) regarding trusts grandfathered from the GST tax.

G. At least 22 states have decanting statutes.

1. Alaska Statutes § 13.36.157.

2. Arizona Revised Statutes § 14-10819.

3. 12 Delaware Code § 3528.

4. Florida Statutes § 736.04117.

5. 760 Illinois Compiled Statutes § 5/16.4

6. Indiana Code § 30-4-3-36.

7. Kentucky Revised Statutes § 386.175

8. Michigan Compiled Laws §§ 556-115a and 700-7820a

9. Missouri Revised Statutes § 456.4-419.

10. Nevada Revised Statutes § 163.556.

11. New Hampshire Uniform Trust Code § 564-B:4-418.

12. New York EPTL § 10-10.6.

13. North Carolina General Statutes § 36C-8-816.1.

14. Ohio Revised Code § 5808.18.

15. Rhode Island General Laws § 18-4-31.

16. South Carolina Code of Laws § 62-7.

17. South Dakota Codified Laws § 55-2-15.

18. Tennessee Uniform Trust Code § 816(b)(27).

19. Texas Property Code §§ 112.071 - 112.087.

20. Virginia Code § 55-548.16-1.

21. Wisconsin Statutes § 701.0418.

22. Wyoming Statutes § 4-10-816(a)(xxviii).

H. Some states do not require that the trustees' discretion be absolute.

I. New Jersey does not have a similar statute. Nor is there any case law in New Jersey involving the appointment by a trustee in further trust. However, several cases, taken together, suggest that New Jersey would permits a beneficiary who could have appointed outright to appoint in trust unless expressly prohibited. *Matter of Wold*, 310 N.J. Super. 382 (Ch. Div. Middlesex Co. 1998); *National State Bank of Newark v. Morrison*, 9 N.J. Super. 552 (Ch. Div. 1950); *Guild v. Mayor*, 87 N.J. Eq. 38 (1916). *See also Matter of Wiedenmayer*, 254 N.J. Super. 534 (App. Div. 1969).

J. Some cases have permitted decanting. *Matter of Spencer*, 232 N.W.2d 491 (Iowa 1975); *Phipps v. Palm Beach Trust Co.*, 142 Fla. 782, 196 So. 299 (1940).

K. *See* Alan Halperin and Michelle R. Wandler, "Decanting Discretionary Trusts," 29 BNA Tax Management Estates, Gifts & Trusts Journal No. 5 (Sept. 2004).

L. The Internal Revenue Service sought public comment on various tax issues and consequences resulting from decanting. Notice 2011-10, 2011-52 IRB 932 (Dec. 20, 2011). Generally, this area remains under study, and the Service will not issue private letter rulings with respect to transfers that result in changes of beneficial interests.

M. You may limit the credit shelter to the state exempt amount, and let the surviving spouse decide whether to disclaim all or part of the marital share.

N. However, there are some possible disadvantages to a disclaimer plan.

1. The spouse may not disclaim.

2. Disclaimer trusts are less flexible.

3. The spouse may not have any power to direct the beneficial enjoyment of the disclaimed property, except as limited by an ascertainable standard. Sections 2518(b)(4); Treas. Reg. § 25.2518-2(e)(2).

4. The spouse may disclaim the power to make discretionary distributions and still remain as a trustee. PLR 9245011.

5. The surviving spouse must disclaim, if at all, within nine months after the first spouse's death (or nine months after the surviving spouse reaches age 21, if later), and before accepting the disclaimed property or any benefits from it. Section 2518(b).

## XII. <u>Reformation of a Trust May Not Be Respected</u>

A. Permissible appointees are considered as beneficiaries for purposes of determining whether there is a designated beneficiary, and if so, the identity of the oldest trust beneficiary.

B. In PLR 200121038, a trust was reformed to eliminate charitable beneficiaries as permissible appointees. The Service did not respect the reformation.

C. The Service had previously respected reformations of trusts. PLRs 200620026 and 200235038 through 200235041.

D. Decanting may be a better solution. *See* PLR 200537044.

E. The Service has also allowed the holder of a power of appointment to release the power to the extent it permitted him or her to appoint in favor of anyone older than the desired oldest beneficiary, or anyone other than a natural person. PLR 201203033.

## XIII. <u>Transferring an Inherited IRA Out of a Trust</u>

A. When an IRA is payable to a trust that pays outright to beneficiaries, the fiduciary naturally wishes to distribute the benefits in the most tax efficient manner to effectuate the closing of the trust at the point in time that the trust is to be distributed outright.

B. Making an in-kind distribution to inherited IRAs for the benefit of the trust beneficiaries meets that objective.

C. Example 1: Alex dies and leaves his IRA to his revocable living trust. The trust passes outright to Alex's son, Nicholas, when he turns 35. Assuming the trust qualifies as a designated beneficiary, Nicholas's life expectancy can be used to calculate required minimum distributions from the IRA. Because the trust pays everything outright to Nicholas when he turns 35, the trustee would like to distribute the trust assets and close the trust.

D. Fiduciaries have been allowed to transfer an IRA to an inherited IRA for the benefit of trust or estate beneficiaries without any adverse tax consequences, thereby allowing the termination of the trust.

E. Direct rollovers, or trustee-to-trustee transfers, are permissible for non-spousal beneficiaries. Rev. Rul. 78-406, 1978-2 C.B. 157.

F. In PLR 201430022, the decedent established a trust which he named as primary beneficiary of his IRA.

1. The trust provided that, after certain specific distributions were satisfied, the balance of the trust was to be distributed to a number of individual beneficiaries.

2. The trustee proposed to divide the IRA via trustee-to-trustee transfers into inherited IRAs, one for the benefit of each of the trust beneficiaries, each in the name of the decedent.

3. The Service ruled that the division of the IRA by means of trustee-to-trustee transfers into the inherited IRAs would not result in taxable distributions or payments under Section 408(d)(1) and would not constitute a transfer causing inclusion in the gross income of the trust or the beneficiaries under Section 691(a)(2).

4. See also PLRs 201241017, 201210047 and 201038019.

G. In a number of the PLRs, the Service stated that Rev. Rul. 78-406 is applicable if the trustee-to-trustee transfer is directed by the beneficiary of an IRA after the death of the IRA owner as long as the transferee IRA is set up and maintained in the name of the deceased IRA owner for the benefit of the beneficiary. The IRS has further stated that the beneficiary accomplishing such a post-death trustee-to-trustee transfer need not be the surviving spouse of a deceased IRA holder.

H. The problem practitioners frequently run into when attempting to effectuate this type of transaction is the willingness of the IRA custodian to cooperate. Potential solutions:

1. Moving to friendlier custodian.

2. Opinion letter.

3. Private letter ruling (costly).

## XIV. **Transferring Qualified Plan Benefits to a Trust**

A. A nonspouse beneficiary may transfer inherited qualified retirement plan benefits to an inherited IRA. Section 402(c)(11).

B. This applies to trusts that qualify as a designated beneficiary. Trusts that do not qualify cannot take advantage of this provision.

C. When the transfer is made, the receiving IRA should be titled as an inherited IRA for the benefit of the beneficiary.

D. Advantage: a qualified plan will often require a quicker payout than the law otherwise allows. The beneficiary may transfer the plan benefits to an inherited IRA and utilize the life expectancy payout allowed by the Internal Revenue Code if the transfer occurs by December 31 of the year following the year of death..



By **Bruce D. Steiner**

# Using Portability for Retirement Benefits

Under ATRA, IRA owners can have their cake and eat it too

The American Taxpayer Relief Act of 2012 (ATRA)[1] made the applicable exclusion amount (estate tax-exempt amount) permanent at $5.25 million, indexed for inflation. It also made portability permanent.[2]

For this purpose, "permanent" doesn't mean that the estate tax-exempt amount will never change. Indeed, the Obama administration has proposed reducing the estate tax-exempt amount to $3.5 million, effective in 2018, and repealing the indexing of the exempt amount for inflation.[3] However, the administration proposes to retain portability. The higher exemption amount and portability provisions in ATRA open up some new possibilities when it comes to retirement benefits planning.

## Statutory History

The estate tax-exempt amount was substantially lower for many years. The Economic Recovery Tax Act of 1981[4] increased the exempt amount from $175,625 to $600,000, phased in from 1982 through 1987. The Taxpayer Relief Act of 1997[5] increased the exempt amount from $600,000 to $1 million, phased in from 1998 through 2006. The exempt amount had reached $675,000 in 2001 when the Economic Growth and Tax Recovery Reconciliation Act of 2001 (EGTRRA)[6] increased it to $1 million in 2002-03, $1.5 million in 2004-05, $2 million in 2006-08 and $3.5 million in 2009. Under EGTRRA, there wouldn't have been any estate tax in 2010. However, the prior law would have returned in 2011, with a $1 million exempt amount.

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010[7] reinstated the estate tax for 2010, with a $5 million exempt amount, but allowed estates to elect carryover basis (with certain adjustments) in lieu of estate tax. The exempt amount was $5 million in 2011, indexed for inflation, and portability was introduced. However, the pre-EGTRRA law was scheduled to return in 2013, with a $1 million exempt amount. ATRA made permanent the $5 million exempt amount, indexed from 2011, and made portability permanent.

## Credit Shelter Trusts

Before portability, most married individuals left the estate tax-exempt amount to a credit shelter trust, so that the assets would be available for the benefit of the surviving spouse, but wouldn't be included in the surviving spouse's estate. Under portability, it's no longer necessary to create a credit shelter trust to keep the exempt amount out of the surviving spouse's estate. However, there are still some benefits to creating a credit shelter trust. Since portability isn't indexed for inflation, the credit shelter trust can shelter not only the exempt amount, but also the income and growth thereon during the surviving spouse's lifetime. In addition, portability isn't available for the generation-skipping transfer (GST) tax exemption. Therefore, the credit shelter trust still makes sense for larger estates.

In smaller estates, a credit shelter trust may not be necessary to eliminate the estate tax and to shelter all of the assets from GST tax. However, there's still a tradeoff. On one hand, the credit shelter trust protects against the surviving spouse's potential creditors and future spouses and may provide protection if the surviving spouse ever wants Medicaid. On the other hand, trusts are generally subject to income tax at higher rates, and the assets in the credit shelter trust won't receive a basis step-up at the surviving spouse's death.

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In this regard, ATRA increased the income tax cost of retaining income in a trust. A trust reaches the top income tax rate at $11,950 of taxable income. ATRA increased the top income tax rate from 35 percent to 39.6 percent. At the same time, ATRA made permanent the income tax rate reductions enacted in 2001 and 2003 for individuals with income under $400,000 (single) or $450,000 (joint). Similarly, under the Affordable Care and Patient Protection Act, the 3.8 percent Medicare tax on net investment income applies to trusts with taxable income over $11,950, but doesn't apply to individuals with taxable income under $200,000 (single) or $250,000 (joint). As a result, more beneficiaries will be in lower tax brackets than their trusts.

Trustees can mitigate the income tax cost by making distributions to carry out income. However, if the trustees distribute income, this will throw the income into the beneficiaries' estates and subject it to the beneficiaries' potential creditors, including ex-spouses. While it may sometimes be possible to distribute capital gains, it may not always be an option.[8]

Some states have state estate taxes, with exempt amounts lower than the federal exempt amount. For example, the exempt amount is $1 million in New York and $675,000 in New Jersey. Some states allow separate, state-only qualified terminable interest property (QTIP) elections, and others allow separate, state-only QTIP elections only when no federal estate tax return is filed. However, a detailed discussion of the issues involving state estate taxes is beyond the scope of this article.

## Retirement Benefits

When the estate tax-exempt amount was lower, many participants and individual retirement account owners didn't have sufficient nonretirement assets to fully fund the credit shelter trust. To that extent, they were faced with a tradeoff between the income tax advantages of leaving the retirement benefits to their spouse and the potential estate tax benefits of leaving the retirement benefits to the credit shelter trust or to or in trust for their children or grandchildren.

There are several income tax benefits to leaving retirement benefits to a spouse. The spouse can roll them over into an IRA, name new beneficiaries, obtain a longer deferral period and convert to a Roth IRA. However, the retirement benefits will be included in the spouse's estate.

By leaving retirement benefits to a credit shelter trust, the benefits will be available for the spouse's use and won't be included in the spouse's estate. However, at best, the benefits will have to be distributed over the spouse's life expectancy based on single life tables, instead of the two-life tables that apply to the spouse's own retirement accounts.[9] This gives up a substantial amount of income tax deferral,[10] in addition to subjecting the retirement benefits to income taxation at the trust's tax rates. The trustees can mitigate the income tax cost by making distributions. However, that will throw the distributions into the recipient's estate and expose them to the recipient's creditors, including ex-spouses, thus destroying the benefits of the credit shelter trust as to the amounts distributed.

Another possibility is to leave the retirement benefits to or in trust for the children or grandchildren. This allows the retirement benefits to be paid over the life expectancy of the children or grandchildren (limited to the life expectancy of the oldest beneficiary in the case of a trust) and keeps the retirement benefits out of the spouse's estate. However, the retirement benefits payable to or in trust for the children or grandchildren will no longer be available for the spouse.

Under ATRA, more participants and IRA owners can

By electing portability, the surviving spouse can receive the benefit of the deceased's unused estate tax-exempt amount.



leave their retirement benefits to their spouses, allowing them to have their cake and eat it too. By leaving the retirement benefits to their spouses, they can take advantage of the income tax benefits of the rollover. The spouse can name new beneficiaries, get a longer income tax deferral and, possibly, convert to a Roth IRA. By electing portability, the surviving spouse can receive the benefit of the deceased's unused estate tax-exempt amount. While portability isn't indexed for inflation and isn't available for purposes of the GST tax, the income tax benefits of the rollover and the possible Roth conversion will often outweigh portability's lack of indexing and its unavailability for GST tax purposes.

Bifurcating the retirement benefits destroys the ability to leave assets in a marital or credit shelter trust.

In this regard, the ability of the surviving spouse to convert to a Roth IRA is more valuable under ATRA. Providing in trust for children and grandchildren, rather than outright, keeps the assets out of the their estates and provides protection against creditors and spouses. However, trusts reach the 39.6 percent income tax bracket at $11,950 of taxable income. Because the surviving spouse won't reach the 39.6 percent income tax bracket until $400,000 of taxable income (and the 35 percent bracket only applies to single taxpayers with taxable income between $398,350 and $400,000), many surviving spouses can convert to a Roth IRA at a tax bracket below 35 percent. This will allow them to obtain the benefits of both the Roth conversion and leaving the retirement benefits to the children or grandchildren in trust, rather than outright, while incurring income tax at rates lower than 35 percent.[11]

## Other Factors

Notwithstanding the increased exempt amount and portability, there will still be cases in which leaving all of the retirement benefits to the spouse may not be appropriate.

One such situation is a second marriage in which the retirement benefits are greater than the amount the participant or IRA owner wants to leave to her spouse. In this case, the participant or IRA owner could leave a portion of the retirement benefits to her spouse and a portion to or in trust for her children or grandchildren.[12] However, bifurcating the retirement benefits destroys the ability to leave assets in a marital or credit shelter trust that can provide the spouse whatever amounts she needs from time to time, while preserving for the children whatever amounts she doesn't need. This can be solved by leaving a portion of the retirement benefits to the spouse, a portion in trust for the spouse and a portion to or in trust for the children or grandchildren.

Another such situation occurs when the spouse is a spendthrift. If the participant or IRA owner were to leave the retirement benefits to the spouse, there's a concern that she would squander them. One solution is to leave some or all of the retirement benefits to or in trust for the children or grandchildren and other assets in trust for the spouse.

## Endnotes

1. P.L. 112-240, H.R. 8, 112th Cong., 2d Sess.
2. For a comprehensive discussion of portability, *see* Stephanie G. Rapkin, "Portability: The New Estate Plan Modality," *Trusts & Estates* (May 2013), at p. 34.
3. General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013), *www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.*
4. P.L. 97-34.
5. P.L. 105-34.
6. P.L. 107-17.
7. P.L. 111-312.
8. Treasury Regulations Section 1.643(a)-3.
9. For a detailed discussion of trusts as beneficiaries of retirement benefits, *see* Bruce D. Steiner, "Trusts as Beneficiaries of Retirement Benefits," 29 *Estates, Gifts & Trusts J.* 108 (March 2004).
10. For a detailed discussion of this point, *see* Christopher R. Hoyt, "Retirement Assets to a Surviving Spouse: Rollovers and Portability Are Your First Choice," 26 *Probate & Property* No. 1, *http://ssrn.com/abstract=2014996* (Jan./Feb. 2012).
11. *See* Bruce D. Steiner, "Roth Conversions Are More Attractive Under ATRA," *Trusts & Estates* (April 2013), at p. 13.
12. In the case of a qualified plan, the spouse may be entitled to some or all of the retirement benefits under Internal Revenue Code Section 417. In addition, the spouse may be entitled to an elective share under state law.

By Bruce D. Steiner

# Before Setting Up A Trusteed IRA

Consider these potential pitfalls

Internal Revenue Code Section 408(a) defines an IRA as "a trust. . . for the exclusive benefit of an individual or his beneficiaries." But Section 408(h) permits a custodial IRA to be treated as an IRA for purposes of Section 408[1] and the Treasury Regulations contain similar provisions.[2]

Indeed, in the early years of IRAs, financial institutions generally referred to themselves as "trustees" rather than "custodians," even if the IRA owner made the investment decisions. I remember opening several IRAs with various banks and a mutual fund company back in the 1970s and 1980s, and every time the financial institution referred to itself as "trustee." More recently, financial institutions have taken to referring to themselves as "custodians" and the term "trusteed IRA" has taken on a new meaning.[3]

In recent years, as an alternative to naming a trust or trusts as the beneficiaries of IRA benefits, several financial institutions have added the dispositive terms of a trust following the IRA owner's death to the IRA agreement itself. In this scenario, the financial institution serves as trustee of the IRA for the benefit of the beneficiaries, in accordance with the dispositive provisions set forth in the IRA agreement itself. This is sometimes referred to as a "trusteed IRA."[4]

The trusteed IRA can save the IRA owner the cost of having a trust individually prepared. But the IRA owner can achieve greater flexibility by creating a trust or trusts, either in his will or in a separate trust instrument, to be the beneficiaries of his IRA benefits.[5]

Indeed, before IRA owners choose to go the trusteed IRA route, they should consider these potential problems:

- **Co-trustees**—A testator who names a corporate trustee often names one or more individuals to serve as trustees together with the corporate trustee. Often, the beneficiary of the trust is a trustee. This arrangement is not possible with a trusteed IRA. IRC Section 408(a)(2) requires that the trustee of an IRA be a bank, a credit union "or such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust will be consistent with the requirements of this section." The regulations permit institutions other than banks to serve as trustees. As a practical matter, however, the regulations limit the trustees to financial institutions.[6] An individual cannot be a trustee.[7]
- **Power to Change Corporate Trustees**—A testator who names a corporate trustee often gives the beneficiary (or someone else) the power to remove the corporate

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trustee and replace it with another corporate trustee, or some other independent trustee. This arrangement is permitted under Revenue Ruling 95-58,[8] *Estate of Vak v. Commissioner*[9] and *Estate of Helen S. Wall*.[10] Indeed, according to one private letter ruling, if the person holding that power is not the grantor, it may not be necessary for the replacement trustee to be independent.[11] But, because a PLR is not binding on the Service except with respect to the taxpayer to whom it is issued,[12] prudence suggests requiring that the replacement trustee be independent.

There is, of course, no reason that a trusteed IRA could not permit the beneficiary (or someone else) to have the power to remove and replace the corporate trustee. One of the trusteed IRAs that I've reviewed suggested that the financial institution might permit the beneficiary to remove and replace the corporate trustee, but offered no assurance that it would do so. The relevant provision stated: "The trustee, in its sole discretion, may refuse to transfer any inherited IRA for any beneficiary who is subject to [trust terms] unless the successor custodian or trustee agrees in writing to administer the inherited IRA in accordance with the [trust terms]." Another trusteed IRA that I examined did not contain such a provision.

• **Flexibility of Dispositive Provisions**—There are no restrictions on the dispositive terms that a trusteed IRA could contain. But the only way to customize the dispositive terms is to individually draft them, in which case there is no need for a trusteed IRA.

The trusteed IRAs that I've reviewed offer a limited menu of choices from which the IRA owner can select. While there is nothing to limit the choices offered, the trusteed IRAs I've seen did not permit maximum flexibility.

• **Discretion Over Income and Principal**—In the trusteed IRAs I've reviewed, the trustee did not have complete discretion to distribute the income and principal to or for the benefit of the beneficiary and his or her issue, or to accumulate the income.[13] The trustee could not retain any of the required distributions from the IRA in the trust. Instead, the trustee was required to distribute these amounts to the beneficiary. To the extent of these mandatory distributions, the opportunity to protect the IRA benefits from the beneficiary's potential creditors (including spouses) is destroyed. Moreover, if the beneficiary lives to life expectancy, which by definition will happen 50 percent of the time, all of the IRA benefits, which could have been kept out of the beneficiary's estate, will be thrown into the beneficiary's estate for estate-tax purposes.

> The IRA owner already will have paid to have a trust prepared. So, cost saving shouldn't be key in deciding on a trusteed IRA.

While inconsistent with a provision mandating a certain level of distributions, one of the trusteed IRAs I've reviewed limited distributions in excess of those mandated to specified purposes. What if it is desirable to make a discretionary distribution for a purpose other than those enumerated? The other one contained a blank space where the IRA owner could "augment [the] beneficiaries' rights to distributions by inserting additional provisions below (for example, grant the trustee the power to pay more at its discretion or for XYZ reason)."[14]

In the trusteed IRAs I've reviewed, each trust had only one current beneficiary to whom the trustee can make distributions. What if it would be desirable to make a distribution to a child or grandchild of the beneficiary?

• **Powers of Appointment**—Testators often give beneficiaries powers of appointment over trusts for their benefit. This provides additional flexibility, and enables the beneficiary to transfer assets to others without incurring estate or gift tax. But in the trusteed IRAs I've reviewed, the beneficiary did not have a special power of appointment exercisable during lifetime. In one of the trusteed IRAs, if the beneficiary had a power of appointment exercisable at death, it was a general power rather than a special power, thus throwing the entire value of the trust into the beneficiary's estate for estate-tax purposes. In the other, the IRA owner could give the beneficiary either a general or a special power of appointment exercisable at death, could make the power of appointment conditional, and in the case of a special power, could specify the class of permissible appointees.[15]

• **Cost Savings Should Not be a Major Factor**—An IRA owner who wants to leave his IRA in trust rather than outright will probably leave his other assets in trust as well. Thus, the IRA owner already will have incurred the cost of having a trust or trusts prepared. The only modification needed to create a trust or trusts to receive IRA benefits is to provide that no accumulated IRA benefits can be distributed or appointed to anyone born in a year prior to the year of birth of the desired designated beneficiary.

## We'll See

Clearly I'm not a big fan of the trusteed IRA—at least not yet. But if you are, I hope I've given you some issues to consider.

### Endnotes

1. Internal Revenue Code Section 408(h) states: "For purposes of this section, a custodial account shall be treated as a trust if the assets of such account are held by a bank (as defined in subsection (n)) or another person who demonstrates, to the satisfaction of the Secretary, that the manner in which he will administer the account will be consistent with the requirements of this section, and if the custodial account would, except for the fact that it is not a trust, constitute an individual retirement account described in subsection (a). For purposes of this title, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof."
2. Treasury Regulations Section 1.408-2(d).
3. While Section 408(a) sets forth certain requirements for the governing instrument creating the IRA, it doesn't prevent the inclusion of additional provisions and the Internal Revenue Service forms for IRAs actually provide space to do so. Article VIII at the end of the two forms the IRS has issued for traditional IRAs (Form 5305, "Traditional Individual Retirement Trust Account" and Form 5305-A, "Traditional Individual Retirement Account Custodial Account) states that it: "may be used for any additional provisions. If no other provisions will be added, draw a line through this space. If provisions are added, they must comply with applicable requirements of state law and the Internal Revenue Code."
4. I've reviewed two forms of trusteed IRAs, one from a national brokerage firm and the other from a regional bank.
5. For a more detailed analysis of trusts as beneficiaries of retirement benefits, *see* Bruce D. Steiner, "Trusts as Beneficiaries of Retirement Benefits," 29 *BNA Tax Management Estates, Gifts & Trusts J. No. 2*, 108 (March-April 2004).
6. Treas. Regs. Section 1.408-2(e),
7. Treas. Regs. Section 1.408-2(e)(2)(i)(A).
8. 1995-2 Cum. Bull. 191.
9. *Estate of Vak v. Commissioner*, 973 F.2d 1409 (8th Cir. 1992), rev'g T.C. Memo 1991-503.
10. *Estate of Helen S. Wall*, 101 T.C. 300 (1993).
11. Private Letter Ruling 199909016.
12. Section 6110(j)(3); Treas. Regs. Section 301.6110-7(b).
13. If the trust is intended to qualify for the estate tax marital deduction as a qualified terminable interest trust under IRC Section 2056(b)(7), the spouse must be entitled to all of the income of the trust, and no principal of the trust can be distributed to anyone other than the spouse during the spouse's lifetime. It's not common to leave an IRA to a qualified terminable interest property trust, because generally the IRA must be paid out over the spouse's life expectancy, thus sacrificing substantial income tax deferral.
14. This provision may be inconsistent. Granting the trustee discretion does not necessarily give the beneficiary any rights. It can be argued that limiting the trustees' discretion to distribute to specified purposes might give the beneficiary a right to receive distributions for the specified purposes. A discussion of this issue is beyond the scope of this article.
15. To obtain the desired stretch out, no accumulated IRA distributions can be distributed to or appointed to or in trust for any individual born in a calendar year earlier than that of the desired designated beneficiary, or to or in trust for anyone other than an individual. PLRs 200228025 and 200235038. In the case of a special power of appointment, the class of permissible appointees must be limited accordingly. For the beneficiary to have a general power of appointment exercisable at death, either the power cannot extend to any accumulated IRA distributions (which may add some drafting complexity), or the trust must mandate that the trustee distribute each year's required distributions from the IRA to a beneficiary (which limits the flexibility of the trust).