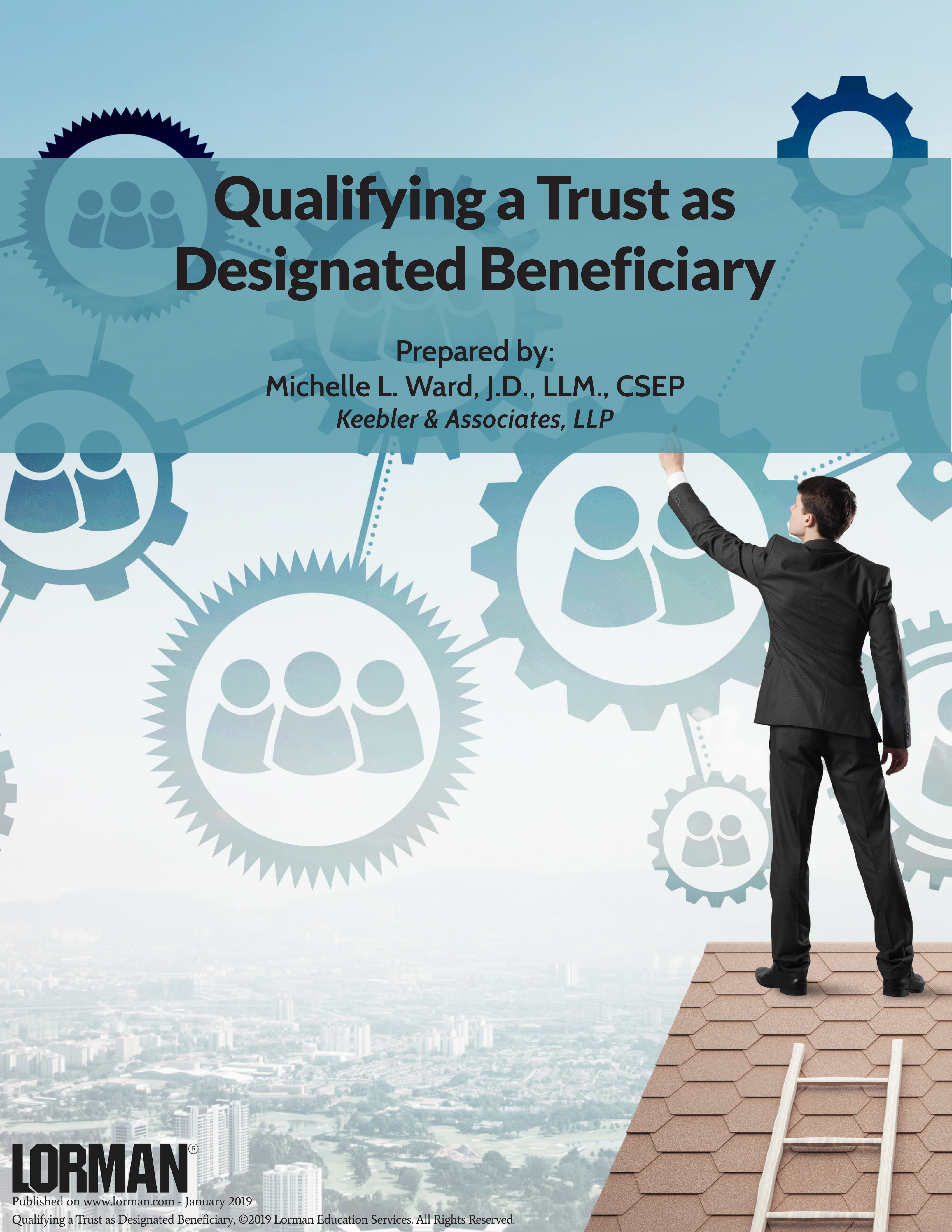

Qualifying a Trust as Designated Beneficiary

Prepared by:
Michelle L. Ward, J.D., LLM., CSEP
Keebler & Associates, LLP

LORMAN®
Published on www.lorman.com - January 2019

TRUST AS BENEFICIARY OF RETIREMENT ASSET

Michelle L. Ward, JD, LLM, CSEP
Keebler & Associates, LLP
michelle.ward@keeblerandassociates.com

I. Qualifying a Trust as "Designated Beneficiary"

A. Qualifying a Trust to Achieve "Designated Beneficiary" Status Under the Final Regulations. Where certain requirements are met, it is possible to achieve Designated Beneficiary status when naming a trust as designated beneficiary. Note however that the trust itself in not a "Designated Beneficiary." Rather, one is able to look through the trust to the individual beneficiaries who are then treated as having been designated. The failure of a trust to achieve Designated Beneficiary status will require post-death distributions over the Owner's life expectancy (if the owner dies on or after his or her RBD)[1] or under the five-year rule (if the owner dies prior to his or her RBD).[2]

1. The test that must be satisfied in order to allow for "Designated Beneficiary" status when a trust is named is found under Treas. Reg. § 1.401(a)(9)-4, A-5(b). The test has four requirements:

[1] Treas. Reg. § 1.401(a)(9)-5, A-5(c)(3).
[2] Treas. Reg. § 1.401(a)(9)-3, A-1.

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

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

c) The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable from the trust instrument within the meaning of A-1 of this section.

d) The documentation described in A-6 of this section has been provided to the plan administrator.

B. First Element: Trust Must Be Valid Under State Law. Generally, this element of the test is relatively easy to meet. While a question existed under the 1987 proposed regulations as to whether testamentary trusts would qualify under this standard, the 2001 proposed and ultimately, the final regulations make it clear that a testamentary trust will satisfy this first element. Treas. Reg. § 1.401(a)(9)-5, A-7, Example 1.

C. Second Element: Irrevocable upon Death. The second element is also relatively easy to meet. Generally, a testamentary trust or probate avoidance revocable trust will become irrevocable upon the death of the Owner. However, in some instances, this element may be cause for problems. For example, a Revocable Trust may be created to be the recipient of Retirement Assets of both spouses. In order to satisfy this test, the trust would have to become irrevocable upon the death of the first spouse.

D. Third Element: Beneficiaries Identifiable from Trust Instrument. The objective in this element is to ascertain the “countable” trust beneficiary with the shortest life expectancy (i.e., the oldest beneficiary). Further, all such countable beneficiaries must be individual beneficiaries. This third element often is the most difficult issue to address when naming a trust.

E. Fourth Element: Documentation Provided to the Plan Administrator

1. As lifetime distributions are based upon the uniform table, except where a spouse is sole beneficiary and is more than 10-years younger than the IRA owner, the need to provide documentation to the plan administrator rarely arises, except where this situation exists. Where the exception is applicable, documentation should be provided no later than the Owner’s Required Beginning Date (“RBD”). Treas. Reg. § 1.401(a)(9)-4, A-6(a).

2. Upon the death of the participant, the trustee of the trust must provide the plan administrator with either[3]:

a. A final list of all beneficiaries of the trust (including contingent and remaindermen beneficiaries with a description of the conditions on their entitlement) as of September 30th of the calendar year following the calendar

[3] Treas. Reg. § 1.401(a)(9)-4, A-6(b).

year of the employee's death; certify that, to the best of the trustee's knowledge, this list is correct and complete and that the trust is valid under state law, the trust is irrevocable upon death, and the beneficiaries are identifiable from the trust instrument; and agree to provide a copy of the trust instrument to the plan administrator upon demand; or

b. A copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee's date of death.

F. Generally, a beneficiary designation may reference a class-of-beneficiaries that is capable of expansion or contraction and still satisfy the “individual” beneficiary requirement. Treas. Reg. § 1.401(a)(9)-4, A-1.

G. What Entities or Beneficiaries (potential or otherwise) under a Trust must be taken into account to determine whether all trust beneficiaries are identifiable individuals?

1. The regulations do not provide a clear answer with regard to who is to be considered a beneficiary of the trust. Rather, we begin our analysis by reviewing the statutory framework.

a. Treas. Reg. § 1.401(a)(9)-5, A-7(a)(2) provides generally that where multiple beneficiaries exist as of the September 30th beneficiary determination date and one of those beneficiaries is not an “individual” the owner is treated as not having a designated beneficiary.

b. Treas. Reg. § 1.401(a)(9)-5, A-7(a)(1) provides that where multiple individual beneficiaries exist, the beneficiary with the shortest life expectancy is the designated beneficiary for purposes of determining the distribution period.

c. Treas. Reg. § 1.401(a)(9)-5, A-7(b) provides that “Except as provided in paragraph (c)(1) of this A-7, if a beneficiary's entitlement to an employee's benefit after the employee's death is a contingent right, such contingent beneficiary is nevertheless considered to be a beneficiary for purposes of determining whether a person other than an individual is designated as a beneficiary (resulting in the employee being treated as having no designated beneficiary under the rules of A-3 of §1.401(a)(9)-4) and which designated beneficiary has the shortest life expectancy under paragraph (a) of this A-7.”

d. Treas. Reg. § 1.401(a)(9)-5, A-7(c)(1) provides that a potential beneficiary need not be counted where such beneficiary is a “mere potential successor to the interest.”

2. The question thus becomes not who *is* (or is likely to be) a beneficiary of the trust, but rather, at what point can we stop the inquiry as to class of potential beneficiaries. In this regard, it will be

necessary to review the structure of the trust to determine what beneficiaries are to be considered.

3. Estate or Charitable Beneficiaries. Based upon Treas. Reg. § 1.401(a)(9)-5, A-7, it is clear that where a non-individual beneficiary is a countable beneficiary of a trust, such as a charity or an estate, such trust will not qualify for Designated Beneficiary Status. This issue may arise in an unexpected manner, such as where Trust assets are available for the payment of the Owner's estate tax, expenses of administration, and debts of the estate. In this case, the Service has argued that the estate is a de facto beneficiary. Several PLRs have highlighted this issue. See PLRs 9809059, 9820021, 199912041 and 200010055. In this regard, where a trust is used, it would be prudent to include a provision in the trust to preclude the use of Retirement Assets for this purpose. Alternatively, the trust may provide for payment of such expenses, provided that such payment occurs only prior to September 30th of the year following the year of death.

4. Based upon Treas. Reg. § 1.401(a)(9)-5, A-7, we generally can classify trusts (to which retirement assets are paid) as falling into one of two categories. This initial classification will allow us to then analyze which beneficiaries need to be taken into consideration.

   a. Conduit Trusts. This structure requires that as each distribution is received by the trust, the trust merely distributes the same to the current beneficiary. Therefore, the trust does not "trap" any of the RMDs inside of the trust. Where a conduit trust exists, one need not consider remainder beneficiaries or potential appointees. This result is confirmed by Example 2 of Treas. Reg. § 1.401(a)(9)-5, A-7(c)(3). See also PLRs 199931033, 200106046 and 200537044.

b. "Accumulation" Trusts. These types of trusts allow for accumulation of IRA distributions within the trust. The key analysis with this type of trust is to determine which beneficiaries (or potential beneficiaries) must be taken into account.

5. In many, if not most cases, the trust will be structured as an "accumulation" trust. Thus, an analysis is required as to whether the trust will qualify.

a. When dealing with an accumulation trust, all *potential* beneficiaries (contingent or otherwise) must be taken into account in determining whether a designated beneficiary exists, unless such beneficiary is a mere potential successor. Treas. Reg. § 1.401(a)(9)-5, A-7(c).

b. Where the trust may accumulate IRA distributions, one now must determine who the potential beneficiaries are of the trust. This requires consideration of all contingent beneficiaries, limited and general powers of appointment, and in some cases, the failure of beneficiaries clause.

c. Where an accumulation trust is named, the inquiry as to which beneficiaries are countable ends when the potential no longer exists for trust accumulation. In this regard, where an outright distribution would occur to a then living beneficiary, such inquiry would end at that beneficiary. See PLRs 200228025, 200528035 and 200610026.

d. Example, assume a trust is created for child #1. Distributions may be made from this trust for the child's health, education, support or maintenance. Upon the child reaching age 30, the trust terminates. Further, assume that the trust requires that should child #1 die prior to full distribution, the balance of the trust is then payable outright to the child's issue, or failing that, his siblings. We will assume that the IRA owner dies when the beneficiary is age 12 (and has no issue). In this case, as of the September 30th beneficiary determination date, the IRA may be accumulated in trust for the child and subsequent beneficiaries, therefore, we must take into consideration the child's siblings. Is this the end of the inquiry? In this case, yes, as the IRA will be distributed free of trust upon the child's death. However, what if the trust was to remain in existence until such siblings reach age 30 and none are of this age upon the beneficiary determination date? In this case, one would also have to take into consideration the “failure of beneficiaries clause.”

e. In many cases, a share may be retained in trust for multiple generations. In this case, the Service will inquire as to future and remote beneficiaries. If the trust is to be held for children, grandchildren and great-grandchildren, a problem exists if no grandchildren or great-grandchildren are yet born. In this regard, there may be a failure of beneficiaries. In this case, we must take into consideration the possibility that the failure of beneficiaries clause may become operable. The failure of beneficiaries clause will often operate by the laws of intestacy of an elected jurisdiction. Often, this will include the potential for older beneficiaries than the initial trust beneficiary, but also include the potential for escheating to the state. Thus, if this is the case, no designated beneficiary would exist.

f. Where accumulation trusts are used, the language of the regulations appear to end the inquiry at that point where the entire interest (IRA and Trust corpus) will be distributed free of trust.

g. PLR 200228025: A trust was named the beneficiary of an IRA. There were two young children named initial beneficiaries of the trust. Under the terms of the trust, if one of the children died before age 30, the child's share went to the child's issue. If the child had no living issue, the trust went to the other child. If both children died before age 30 without issue, the trust passed to a much older great-uncle. The Service ruled that the great-uncle's life expectancy must be used to determine post-death RMDs.

6. Powers of Appointment. Where the trust includes a power of appointment and is not structured as a conduit trust, consideration must be given to the effect of the power of appointment. Often, the trust will be considered under the "life expectancy" test whereby all potential beneficiaries, including appointees under a power of appointment must be taken into consideration. Such appointment may take the form of a general or limited power of appointment.[4]

    a. General Powers of Appointment. A general power of appointment exists where a beneficiary has the ability to appoint assets to himself, his estate, his creditors, or the creditors of his estate. Only where the general power of appointment is crafted to be exercisable in favor of (a) such beneficiary during the trust term or (b) individual creditors younger than the oldest trust beneficiary, will the general power of appointment be narrow enough to not cause disqualification.

[4] See IRC §§ 2514 and 2041.

b. Limited Powers of Appointment. A limited power of appointment can generally be defined as the power to appoint property to anyone other than the owner, his estate, his creditors, or the creditors of his estate. This power may be drafted on a much narrower basis, such as the ability to appoint property to "issue." In order to satisfy the "beneficiaries identifiable" test, it must be possible to determine the potential appointees in order to ascertain the shortest life expectancy. If, for example, a power to appoint to "issue" is used and adoptees of a child are to be treated as issue, does this satisfy the "beneficiaries identifiable" rule? Although highly improbable, it would be possible (assuming the trust instrument permitted) for a child to adopt an individual older than the oldest trust beneficiary. A solution appears to be to limit the permissible class of beneficiaries to those who are younger than the current beneficiary.

See, for example, PLRs 200235038-200235041. In these PLRs, the initial beneficiaries were given a limited power of appointment. The power of appointment was limited to (1) any individual born in a calendar year prior to the calendar year of birth of the decedent's oldest living issue at the time of the decedent's death, (2) any person other than a trust or an individual, or (3) any trust that may have as a beneficiary an individual born in a calendar year prior to the calendar year of birth of the decedent's oldest living issue at the time of the decedent's death. The Service ruled that the trust was a valid "see-through" trust and that RMDs could be based on the oldest child's life expectancy.

7. Dynasty Trusts (as previously discussed). Treas. Reg. § 1.401(a)(9)-5, A-7(a)(1) generally provides that where multiple beneficiaries exist, such as the case in a Dynasty Trust, and one of those beneficiaries is not an "individual" the owner is treated as not having a designated beneficiary. Further, it is clear that pursuant to Treas. Reg. § 1.401(a)(9)-5, A-7(a)(1), where a non-individual beneficiary may benefit from a trust, such trust will not qualify for Designated Beneficiary status. Thus, the question becomes, in the context of a trust that terminates in favor of (or benefits) a class of unborn beneficiaries, are such potential beneficiaries "individuals?" The trust qualification rules under IRC § 401(a)(9) require us to consider all potential beneficiaries under the trust. Unless the trust is drafted to avoid this, under Wis. Stats. § 852.01(3), the failure of beneficiaries would result in the trust terminating and escheating to the State of Wisconsin. Because the State of Wisconsin is not an individual, the trust would not allow for designated beneficiary status.

H. Naming one's probate avoidance revocable trust as a beneficiary. Often, for convenience and sound estate planning reasons, the probate avoidance trust serves as the funnel through which all assets pass. However, the probate avoidance revocable trust is typically poorly suited to serve as a beneficiary of retirement assets. Some issues to consider are:

1. Is the trust structured to divide into a QTIP trust and Credit Shelter Trust? If so, the QTIP will likely preclude a spousal rollover (which may or may not be appropriate). If the IRA owner dies first, since the surviving spouse is typically a beneficiary of the Credit Shelter Trust, he or she will also likely be the measuring life.

2. How are estate taxes, expense of administration, debts of the decedent to be paid? Will the IRA be part of the assets made available for this?

3. Does the potential exist for acceleration of income tax on the funding of a credit shelter or marital trust?

4. Does the trust contain powers of appointment for flexibility? Do such powers cause trust disqualification? Will the IRA owner want to compromise flexibility by eliminating the powers in order to allow the trust to qualify for designated beneficiary status?

5. Does the trust include charitable or non-individual beneficiaries? Unless the “charitable purge” tool can eliminate the charity or non-individual beneficiaries from consideration, this will cause acceleration of RMDs.

6. Does the fact that the separate share rule does not appear to be applicable where a single trust creates multiple sub-trusts affect the RMDs?

I. QTIP Trusts

1. Revenue Ruling 2006-26.

2. Satisfying the “all income” requirement.

3. Application of Uniform Principal and Income Act.

4. Making the Election for both the Retirement Asset and QTIP Trust.

5. Coordinating the Reverse QTIP Election.

J. Separate Share Rule. The separate share rule found under Treas. Reg. § 1.401(a)(9)-5, A-7 is not available where the beneficiary designation names a trust and such trust creates separate sub-trusts. Instead, the regulations require that the separate shares be specifically named as beneficiaries at the beneficiary designation level. Treas. Reg. § 1.401(a)(9)-4, A-5(c). See PLR 200537044. Further, from a non-tax related structural standpoint, consideration must be given as to whether a separate share trust is even appropriate.

K. Special Spousal Rules Where Benefit is Payable Through Trust. If multiple trust beneficiaries exist, or are deemed to exist (such as in the case of a QTIP trust), RMDs are based upon the Single Life Table. Further, a surviving spousal beneficiary is not entitled to postpone the start of minimum distributions until the owner would have been age 70½ had he or she lived as the spouse is not deemed to be the sole beneficiary. In this case, distributions must begin no later than December 31st of the year following the year of death. When then is a spouse treated as the sole beneficiary of a trust?

If a spouse is the sole primary beneficiary of a conduit trust[5], it appears that the spouse will be treated as sole beneficiary of a trust. Accordingly, the spouse can postpone the start of minimum distributions until the owner would have been age 70½ had he or she lived. In the year RMDs must begin, the RMD is calculated based upon the spouse's life expectancy by referencing her attained age for the year of distribution based on the Single Life Table. For each succeeding year, the surviving spouse references his or her age under the Single Life Table.

PLR 200644022 confirmed this RMD treatment, but also highlighted an unintended result that can occur when utilizing this strategy. When a spouse is treated as a sole beneficiary and does not perform a rollover, if the spouse dies before the owner would have been age 70½, the spouse is deemed to be the owner/participant and a beneficiary is determined as of September 30th of the year following death.[6] In PLR 200644022, the spouse was the sole primary beneficiary of a conduit trust. The spouse died after the IRA owner, but before the owner would have been 70½. Because the IRA was payable to the trust, the spouse did not name a

[5] Any and all amounts distributed from the IRA must be paid outright to the spouse.
[6] Treas. Reg. § 1.401(a)(9)-4, Q&A 4(b).

beneficiary of her interest in the IRA. Thus, the IRS found that the 5-year rule applied to the distribution of amounts remaining in the IRA at the spouse's death (because the spouse was deemed to not have a designated beneficiary). Therefore, caution must be exercised when paying an IRA to a conduit trust for the benefit of a spouse.

L. Single Pot Trusts versus Separate Share Trusts. Non-tax reasons may be more important for a family to maintain an IRA in a single-pot trust rather than as separate shares. This is especially true where the IRA is not substantial and young children are the beneficiaries of the trust.

M. Sample Provisions Specific to Retirement Assets

1. Protecting Retirement Assets from use for Decedent’s Debts, Taxes and Expenses of Administration

Notwithstanding anything herein to the contrary, no payment of taxes of any kind, or payment of debts or expenses of administration shall be made from any Retirement Assets, or the proceeds of such account or plan, for any such taxes, debts or expenses of administration if such payment would cause the Trust or any such plan or account to be considered to have a beneficiary other than a qualified Designated Beneficiary under IRC § 401(a)(9)(D) for purposes of determining required minimum distributions under IRC § 401(a)(9)(A)(ii) and the Regulations thereunder.

2. Creating a General Power of Appointment over a Trust Without Losing "Designated Beneficiary Status."

Upon the death of the Grantor and subsequent death of the Primary Beneficiary, the Trustee shall transfer, convey and pay over the principal of the trust, as it is then constituted, in money and/or in kind, to a group consisting of such individual creditors younger than Primary Beneficiary and/or one or more of the descendants of the Primary Beneficiary who are younger than the Primary Beneficiary. Such appointment shall be made absolutely (not in trust), if at all, to such extent, in such amount or proportions, as the Primary Beneficiary may by his or her Last Will and Testament appoint by specific reference to this power.

3. Excluding Older Adoptees.

Notwithstanding the forgoing, any class of beneficiaries (e.g. "lineal descendants", "issue" or "child") hereunder shall not include an individual who is included in said class by virtue of legal adoption if such beneficiary (i) was adopted on or after September 30th of the year following the Grantors' death, and (ii) is older than the oldest beneficiary of this trust who is a living member of said class on the earlier of said dates.

4. Purging Non-Qualified Beneficiaries.

Notwithstanding other provisions of this Trust agreement, the Trustee may fully payout the interest of any beneficiary who is not an "individual," and is therefore not a qualified beneficiary within the meaning of IRC § 401(a)(9) and the Regulations and Proposed Regulations thereunder, by September 30th of the year following the year of the Grantor's death, if in the Trustee's judgment failure to do so would result in acceleration of distributions from retirement accounts to the detriment of the other beneficiaries or the objectives of this Trust.

5. Failure of beneficiaries clause.

Upon the death of the last of the Grantor's lineal descendants, the Trustee shall distribute the balance then remaining as follows:

All assets and property comprising the Trust Estate directed to be disposed of in accordance with the terms and conditions set forth in this Paragraph shall be distributed to the descendants of the Grantor's parents then living per stirpes, provided that any such descendant born before the oldest initial Primary Beneficiary shall be deemed deceased; in default thereof, the oldest initial Primary Beneficiary's next of kin then living, regardless of how remote their degree of kinship is, provided that persons born before the oldest initial Primary Beneficiary shall be deemed deceased.

With respect to usage of the term "next of kin," it is my intent to override Wis. Stat. § 854.22(1) to eliminate the potential for escheat *to the state of Wisconsin and rather use this term to create interests based on consanguinity.*
