Coordinating Retirement Planning
With Estate Planning

by: Keith A. Herman
Greensfelder, Hemker & Gale, P.C.
10 S. Broadway, Ste 2000
St. Louis, MO 63102
(314) 241-9090

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I. Introduction

A substantial portion of the wealth possessed by Americans today consists of tax deferred retirement accounts such as traditional IRAs, 401(k)s and 403(b)s. In 2002 the IRS issued final regulations under IRC section 401(a)(9), clarifying and simplifying many of the rules applicable to retirement accounts. Treas. Reg. sections 1.401(a)(9)-0 through 1.401(a)(9)-9 and Treas. Reg. section 54.4974-2. These rules apply to 401(k)s, 403(b)s, and IRAs. Treas. Reg. section 1.403(b)-3; Treas. Reg. section 1.408-8. Roth IRAs are addressed in Section III.C.

II. Retirement Accounts Present Unique Problems

In general, the receipt of inherited property is not subject to income tax. The major exception to this rule is retirement accounts, as these accounts represent income that has not been previously taxed. After a taxpayer's death, income tax will be due on the amount withdrawn from the taxpayer's retirement account. When dealing with retirement accounts, the primary goal is to allow the taxpayer's beneficiaries the opportunity to defer this income tax for as long as possible.

An estate planning attorney must deal with all of the following issues regarding a client's retirement accounts:

- Who will be the primary and contingent beneficiary?

- How long can the beneficiary defer withdrawals from the account and the attendant income tax liability?

- Is there is a compelling reason to name a trust as a beneficiary?

- Do any retirement account proceeds passing to a spouse, in trust, qualify for the marital deduction?

- What is the most tax efficient source of payment for estate taxes on the retirement account?

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[1] A version of this article was published in the January/February 2006 edition of Probate & Property, and won the 2006 Best Overall Article Award – Probate & Trust.

III. Distribution Rules During Life and After Death

A. Distributions During The Taxpayer's Lifetime and Charitable IRA Rollovers

The required minimum distribution ("RMD") rules specify how long a taxpayer (and after the taxpayer's death, the beneficiary) may defer withdrawals from retirement accounts. IRC section 401(a)(9). During life, the taxpayer must generally begin taking withdrawals by April 1 of the year after the taxpayer reaches age 70 ½. This date is referred to as the required beginning date ("RBD"). An IRS table that takes into account the taxpayer's life expectancy sets the RMD amount the taxpayer must withdraw in each year after the RBD. Treas. Reg. section 1.401(a)(9)-5.

<u>Charitable IRA Rollovers</u>
Until recently only distributions to the account owner were allowed during the account owner's lifetime – the owner could not assign any portion of a retirement account directly to a third party. Certain distributions may now be made directly to charities. The Pension Protection Act of 2006 added IRC section 408(d)(8), which excludes from gross income "qualified charitable distributions" from traditional and Roth IRAs, of amounts up to $100,000. Some of the key points of this "charitable IRA rollover" legislation are as follows: (i) the provision is only effective for distributions made in 2006 and 2007, (ii) it does not apply to a distribution from a qualified plan, including a 401(k), 403(b), defined benefit plan, profit sharing plan, Keogh, or an employer sponsored SEP or SIMPLE, (iii) the taxpayer must be at least 70 ½ on the date of distribution, (iv) no income tax deduction is allowed as the distribution is never included in gross income, (v) the distribution must be made to a public charity or private operating foundation (not a typical nonoperating private foundation, donor advised fund or supporting organization), (vi) the distribution cannot be in exchange for a gift annuity or split-interest trust, (vii) the distribution must pass directly to the charity, (viii) a substantiation letter is required, and (ix) the qualified charitable distribution may be used to satisfy the account owner's RMD. A beneficiary of an inherited IRA may also make a qualified charitable distribution. Notice 2007-7, Q-37. A qualified charitable distribution may be attractive for (i) donors who do not itemize their deductions (nearly 2/3 of Americans claim the standard deduction), (ii) donors in states with no state income tax charitable deduction (Indiana, Michigan, New Jersey, Ohio, Massachusetts, and West Virginia), (iii) donors who are subject to the 50% of AGI limitation, and (iv) donors who may benefit from keeping their AGI lower (for taxability of social security payments, deductibility of medical expenses, miscellaneous itemized deductions, phase-out of itemized deductions and child tax credit, and application of AMT). For taxpayers who itemize and can claim an offsetting charitable income tax deduction, it will often be administratively easier to take a distribution from the IRA and then make a charitable gift.

Update – On October 3, 2008, Congress passed the Emergency Economic Stabilization Act of 2008, which makes no changes to the substance of the charitable IRA rollover rules, but extends the applicability of the law to gifts made in 2008 and 2009.

Update – As of April 2010, the House and Senate have passed H.R. 4213 that includes a provision which makes no changes to the substance of the charitable IRA rollover rules, but extends the applicability of the law to gifts made in 2010. The law would be retroactive to January 1, 2010. The House and Senate must work together to reconcile their respective bills before the legislation is sent to the President.

B. Distributions After Death if Spouse is Beneficiary (Spousal Rollovers)

A taxpayer can obtain the most favorable income tax results by naming the taxpayer's spouse directly as the primary beneficiary. A surviving spouse is the only person who has the option of rolling over an inherited retirement account into his/her own IRA and treating the IRA as the spouse's own. IRC section 402(c)(9) (qualified plans); IRC section 408(d)(3)(C)(ii) (IRAs). [As explained in the next section non-spouses may now rollover certain qualified plan accounts, but the rollover will be treated as an inherited IRA.] Often the simplest way to accomplish the rollover is to retitle the account into the surviving spouse's name. By rolling over the account, the surviving spouse can defer withdrawals from the account until the spouse turns 70 ½ (any other beneficiary must begin taking withdrawals the year after the taxpayer's death). In addition, the spouse can name his/her own beneficiaries of the IRA that may use a life expectancy payout. When other beneficiaries die, the RMD continues to be based on the deceased beneficiary's life expectancy.

C. Distributions After Death if a Non-Spouse is Beneficiary and Non-Spouse Rollovers

If someone other than the spouse is the beneficiary, the beneficiary's RMD depends on whether there is a "Designated Beneficiary" of the account, as that term is specifically defined in Treasury Regulation section 1.401(a)(9)-5. Although individuals are Designated Beneficiaries, estates, states, charities, and business entities are not Designated Beneficiaries. Treas. Reg. section 1.401(a)(9)-4.

If there is a Designated Beneficiary and the taxpayer died <u>before</u> the taxpayer's RBD, then the beneficiary's RMD is based on an IRS table that takes into account the beneficiary's life expectancy. If there is a Designated Beneficiary and the taxpayer died <u>after</u> the taxpayer's RBD, then the beneficiary's RMD is based on an IRS table that takes into account the longer of the (i) beneficiary's life expectancy or (ii) taxpayer's life expectancy. See Treas. Reg. section 1.401(a)(9)-9 for the IRS tables.

If there is <u>no</u> Designated Beneficiary and the taxpayer died <u>before</u> the taxpayer's RBD, then the beneficiary must withdraw all of the retirement account within 5 years of the taxpayer's death. If there is <u>no</u> Designated Beneficiary and the taxpayer died <u>after</u> the taxpayer's RBD, then the beneficiary's RMD is based on an IRS table that takes into account the deceased taxpayer's life expectancy.

The beneficiary may withdraw more than the RMD, but the beneficiary must withdraw at least the RMD each year to avoid a penalty. When a beneficiary takes his RMD based on his life expectancy it is often referred to as a “stretch”. Although life expectancy payouts in IRAs are common, not all IRAs offer this option. Most qualified plans do not allow a life expectancy payout option, as they typically require a lump sum distribution upon death.

Roth IRAs

Due to the elimination of the $100,000 income limitation on who can convert a traditional IRA to a Roth IRA in 2010 and future years, there may be more large Roth IRAs coming soon. IRC section 408A(c)(3)(B). The RMDs explained above do not apply to Roth IRAs while the account owner is alive, but RMDs are required after the account owner dies (i.e. the beneficiaries of a Roth IRA are required to take RMDs). IRC section 408A(c)(5). The RMD rules apply to the beneficiaries of a Roth IRA as if the account owner had died before his required beginning date. Treas. Reg. section 1.408A-6, A-14(b).

Unlike traditional IRAs, qualified distributions from Roth IRAs are not subject to income tax. IRC Section 408A. However, it is still important to optimize how long beneficiaries of a Roth IRA can defer withdrawals. The benefit of deferring withdrawals from Roth IRAs for as long possible, is that the assets in the account can continue to grow income tax free. In this regard, the advice herein for qualifying the beneficiary of a traditional IRA as a “Designated Beneficiary” also applies to Roth IRAs.

Clients should think carefully before naming a charity as beneficiary of a Roth IRA, as prepaying income taxes on assets being left to an income tax exempt charity is not tax efficient. Compared to a traditional IRA, it is more tax efficient to name grandchildren as beneficiaries of a Roth IRA, as no part of the account will be wasted on the payment of GST taxes (or if the client will allocate GST exemption to the account, no GST exemption will be wasted on assets of the account that must go towards the payment of income taxes – as would be the case with a traditional IRA).

The remainder of this article does not discuss specifically address Roth IRAs.

Non-Spouse Rollovers

However, the Pension Protection Act of 2006 added IRC section 402(c)(11), which, beginning January 1, 2007, allows a non-spouse Designated Beneficiary to rollover a qualified plan account into an IRA by a trustee to trustee transfer. Under prior law, a common approach was to name the client’s revocable trust as the contingent beneficiary of a qualified plan that did not allow a life expectancy payout. It is now important to ensure each beneficiary of a qualified plan is a Designated Beneficiary. This rollover is not as favorable as the spousal rollover, as the non-spouse rollover is treated as an inherited IRA, not as the non-spouse’s contributory IRA. The only benefit to the non-spouse rollover is the ability to transfer the account to an IRA that allows a life expectancy payout option.

The IRS has already issued two clarifications of this law. On January 10, 2007 they issued Notice 2007-7, and on February 13, 2007 they issued a special edition of

Employee Plans News to respond to the confusion caused by the Notice. These IRS clarifications raise several concerns. First, the qualified plan does not have to allow the non-spouse rollover. If the plan does not allow the rollover, there is nothing the beneficiaries can do. This undermines the intent of the legislation to give non-spouse beneficiaries of a qualified plan a way to obtain a life expectancy payout. It is unclear whether the plan must be amended to explicitly allow the rollover. Second, to use a life expectancy payout the rollover must be completed by the end of the calendar year after the year of death, and the first required distribution must also be taken by this same date. If the rollover is not completed by the deadline, the beneficiaries must take distributions according to any plan rules that are more restrictive than a life expectancy payout, such as a 5-year payout. Third, the amount of the beneficiary's first RMD (and any other undistributed RMDs) cannot be rolled over. Fourth, the rollover account must be properly titled identifying both the deceased account owner and the beneficiary. Due to these complications, it is still best to rollover a qualified plan to an IRA during the taxpayer's lifetime, to assure the availability of a life expectancy payout for the beneficiaries.

Update – For plan years beginning after December 31, 2009, qualified plans must allow non-spouse roll-overs. See Section 108(f) of the Worker, Retiree, and Employer Recovery Act of 2008.

D. Separate Accounts and Multiple Beneficiaries

If there are multiple beneficiaries of a retirement account, then the RMD is based on the life expectancy of the oldest beneficiary. Treas. Reg. section 1.401(a)(9)-5, A-7(a)(1). But if separate accounts are "established" for multiple beneficiaries prior to December 31 of the year after the calendar year of the taxpayer's death, then the RMD rules will apply separately to each such separate account. Treas. Reg. section 1.401(a)(9)-4, A-5(c); Treas. Reg. section 1.401(a)(9)-8, A-2(a)(2). A separate account allows you to calculate the RMD based on the life expectancy of the oldest beneficiary of such separate account. To establish separate accounts the beneficiaries interests must be fractional (i.e. not pecuniary). In addition, some affirmative act must establish the separate accounts, such as a physical division of a single account into completely separate accounts or using separate account language on the beneficiary designation form. Whenever possible, it is best to create the separate accounts with appropriate language directly on the beneficiary designation form. See the sample language in the Recommended Beneficiaries in a Typical 1st Marriage Section herein.

E. Eliminating Unwanted Beneficiaries Prior To September 30th

The deadline for determining who are the initial beneficiaries of a retirement account is the date of the taxpayer's death. However, between the taxpayer's death and September 30th of the following year, troublesome or non-individual beneficiaries may be removed by disclaiming the interest, creating separate accounts, or eliminating them as beneficiaries by distributing their benefits outright to them. Treas. Reg. section 1.401(a)(9)-4, A-4(a).

F. Avoiding Trusts As Beneficiaries

Due to the complexity associated with qualifying a trust as a Designated Beneficiary, a revocable trust should usually be avoided as the beneficiary of retirement accounts. Avoid naming a trust as the beneficiary, unless (i) one of the reasons to name a trust as beneficiary outweighs the time and costs of establishing a see-through trust, (ii) one of the reasons to name a trust is more important than the lost income tax deferral of naming a typical nonsee-through trust as beneficiary, or (iii) a life expectancy payout option or spousal rollover is not important or not available. It is usually best to name individuals directly as the beneficiaries of retirement accounts.

G. Recommended Beneficiaries in a Typical 1st Marriage

In a typical first marriage situation (when funding a credit shelter trust is not at issue), the spouse should be named as the primary beneficiary and the adult children as the contingent beneficiaries. If there is a minor child, then a transfers to minors account is a wise alternative. Consider the following language:

> The total account assets shall be divided to provide one equal share of the account, as of my date of death, for each of my children who is either living on my date of death or is deceased on my date of death but who has one or more descendants living on my date of death. Any share created for a deceased child of mine shall be divided into separate shares for such deceased child's descendants, per stirpes. Each such created for a descendant of mine who has not attained the age of twenty-one (21) shall be held by ________________, as a custodian for the descendant under the [state of residency] Transfers to Minors Act or similar minor's custodian law of any state where the minor then resides.
>
> Each of my beneficiaries designated above, shall have the right (with respect to the death benefits as to which that beneficiary is then the Designated Beneficiary) to elect any method of payment available.
>
> The assets of my account shall be segregated, effective as of the date of my death, into separate subaccounts, one for the share representing each beneficiary, so that all postdeath investment gains, losses, contributions and forfeitures are determined separately for each subaccount. Each beneficiary shall have the right to direct changes to investments held in his or her separate subaccount.

This language has three benefits: (i) it ensures a deceased child's portion of the account will pass to the deceased child's children, not to the deceased child's siblings or probate estate, (ii) it ensures the beneficiaries will receive separate account treatment as explained above, and (iii) it provides that a named custodian will have legal authority to handle a minor's portion of the account, thereby avoiding the need to establish a formal conservatorship. However, a custodian of a Transfers to Minors Act account must distribute all of the custodial assets outright to the beneficiary at age 18 or 21, depending on state law. If a client wishes to defer the descendant's control of the account until a later age, then a conduit trust may be appropriate as explained in the Conduit Trusts Section herein.

H. When A Life Expectancy Payout Is Not Important

There are a number of instances when income tax deferral is not important. Income tax deferral will not be important if the beneficiary will withdraw the entire account upon the taxpayer's death for an immediate need, such as to pay estate taxes or to support minor children. Income tax deferral will not be a major consideration if the size of the account is so small that a withdrawal of the entire account will not cause a substantial amount of additional income tax. If the beneficiary is near the taxpayer's age and the taxpayer is over age 70 ½, then naming a Designated Beneficiary will not have a significant effect on the RMD, as the account must be withdrawn over the same time period whether or not the beneficiary is a Designated Beneficiary. Finally, naming a Designated Beneficiary is not an issue if the taxpayer names only charitable organizations as beneficiaries, as the income of charitable organizations is not subject to tax.

I. Charities as Beneficiaries

As charities are exempt from the income tax, they are the ideal beneficiaries of retirement accounts for clients with charitable desires. The retirement account benefits are actually worth more to the charity than other beneficiaries due to this exemption from income taxes. At the planning stage clients have a choice of assets to use to fund their charitable bequests. Attorneys should structure charitable bequests in an estate plan in the most tax efficient way, which usually means utilizing retirement accounts.

1. Name Charities Directly on Beneficiary Designation Form

To avoid adverse tax consequences, charitable bequests of retirement account assets should almost always be made directly on the beneficiary designation form, as opposed to under a will or trust. If there will be multiple beneficiaries of the account, then care must be taken to make sure the charitable beneficiary will not disqualify the other beneficiaries from using a life expectancy payout. There are three ways to avoid losing the life expectancy payout option. First, the client may divide his retirement account into separate accounts during his lifetime. One account would contain the assets that will pass to charity upon death and the other account would hold the excess. The charity would be named as the beneficiary of all of the first account, and would have no interest in the second account. This would qualify as a separate account and the charity would not effect the other beneficiaries' use of a life expectancy payout. Second, separate accounts can be created after death by either using the proper language on the beneficiary designation form or physically dividing the assets into separate accounts prior to December 31 of the year after the calendar year of the taxpayer's death. To qualify for separate account treatment, the charity must be a beneficiary as to a percentage of the account, not a pecuniary (i.e. dollar) amount. The third way to ensure a stretch option is available is to pay off the charity prior to September 30 of the year after the taxpayer's death. Note that this third option is available even if the charity is to receive a pecuniary amount. The drawback to this option is that the September 30 deadline may be missed.

If the spouse is the only other beneficiary of the retirement account, then ensuring a stretch is not important as the spouse can rollover the proceeds into his/her own IRA.

2. When the Charity Must Be Named in the Will or Trust

In some situations, the charity cannot be named directly on the beneficiary designation form, such as when a detailed formula must be used that the retirement account custodian will not accept on a beneficiary designation form or attachment. In these situations the charitable bequest must be made in the will or trust. There are two important issues to be aware of when naming a charity as a beneficiary under a will or trust.

First, it is important to maintain the ability of the noncharitable trust beneficiaries to use a life expectancy payout option. The second issue is ensuring the trust receives an income tax deduction for a distribution to charity, or ensuring the trust never recognizes any income to begin with. Both of these issues are extremely complicated and beyond the scope of this outline. Whenever possible avoid charitable distributions of retirement accounts through wills and trusts, and make the distributions directly on the beneficiary designation form.

IV. Trusts As Beneficiaries

A. Situations In Which Trusts Are Crucial

In some situations a trust must be named as beneficiary, such as when (i) the beneficiary is a special needs child that relies on government benefits, (ii) the beneficiary is a second spouse that the client wants to have limited access to the trust principal, (iii) the beneficiary is a minor, (iv) the beneficiary is a spendthrift or has substance abuse problems, and (v) when retirement account assets must be used to fund a credit shelter trust. In these situations, the client may decide the reason for the trust outweighs the lost income tax deferral, or may decide a see-through trust is appropriate.

B. What Are See-Through Trusts

A trust that qualifies as a Designated Beneficiary is often referred to as a "see-through trust". If a taxpayer names a see-through trust as the beneficiary, then the trust may make withdrawals from the account based on the life expectancy of the oldest beneficiary of the trust (i.e. the trust's RMD is based on the age of the oldest beneficiary). In essence, the trust is ignored and the beneficiaries of the trust are treated as the beneficiaries of the retirement account.

A trust must satisfy five tests to qualify as a Designated Beneficiary see-through trust. The first four tests are as follows: (i) the trust must be valid under state law, (ii) the trust must be irrevocable or become irrevocable at the taxpayer's death, (iii) the trust beneficiaries must be identifiable, and (iv) certain documentation must be provided to the plan administrator or IRA custodian by October 31 of the year after the taxpayer's death. Treas. Reg. section 1.401(a)(9)-4, A-5. If these four tests are met, then the trust is a Designated Beneficiary and the RMD will be based on the <u>oldest</u> trust beneficiary's life expectancy. Treas. Reg. section 1.401(a)(9)-5, A-7(a)(1). But there is, in essence, a fifth test for the trust to be a Designated Beneficiary, as all of the beneficiaries of the trust must be individuals the oldest of whom can be identified. Treas. Reg. section 1.401(a)(9)-4, A-5(c); Treas. Reg. section 1.401(a)(9)-4, A-3. Therefore, the fifth requirement is drafting the trust so that it is possible to determine the identity of the oldest beneficiary, and ensuring only individuals are beneficiaries of the trust. This fifth test often creates problems. In addition, the requirement that the trust beneficiaries must be identifiable is also a problem with multi-generation dynasty trusts (i.e. perpetuity trusts).

C. What Trust Beneficiaries Can Be Ignored

It is difficult to draft a trust that only has individual beneficiaries and where it is possible to ascertain the oldest beneficiary, as the IRS has not told us which contingent beneficiaries can be ignored. The regulations provide that if the first four tests above are met, then the beneficiaries of the trust are considered beneficiaries of the retirement account. The regulations provide two rules in this regard. The general rule is that with respect to determining if there is a beneficiary of the trust that is not an individual (which would disqualify the trust as a Designated Beneficiary), and determining who is the oldest beneficiary, a "contingent beneficiary" must be taken into account. Treas. Reg. section 1.401(a)(9)-5, A-7(b). The second rule provides that

> --(1) A person will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy under paragraph (a) of this A-7, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death. However, the preceding sentence does not apply to a person who has any right (including a contingent right) to an employee's benefit beyond being a mere potential successor to the interest of one of the employee's beneficiaries upon that beneficiary's death. Thus, for example, if the first beneficiary has a right to all income with respect to an employee's individual account during that beneficiary's life and a second beneficiary has a right to the principal but only after the death of the first income beneficiary (any portion of the principal distributed during the life of the first income beneficiary to be held in trust until that first beneficiary's death), both beneficiaries must be taken into account in determining the beneficiary with the shortest life expectancy and whether only individuals are beneficiaries.

Treas. Reg. section 1.401(a)(9)-5, A-7(c)(1).

This rather unhelpful regulation gives us the guidance that a “contingent beneficiary” must be taken into account, but a “mere potential successor” beneficiary can be ignored, but does not explain the meaning of these terms. The regulation also specifically states that you cannot ignore contingent beneficiaries simply because the current beneficiary is entitled to all of the trust income, as is the case with a QTIP trust or QSST.

> . . . if the first beneficiary has a right to all income . . . during that beneficiary’s life and a second beneficiary has a right to the principal but only after the death of the first income beneficiary . . . , both beneficiaries must be taken into account in determining the beneficiary with the shortest life expectancy and whether only individuals are beneficiaries.

Treas. Reg. section 1.401(a)(9)-5, A-7(c)(1). Although the regulation clearly contemplates that some beneficiaries can be ignored, it never really explains the circumstances in which they can be ignored.

Recent private letter rulings take a date of death look at the then living trust beneficiaries to determine which contingent remainder beneficiaries can be ignored. PLRs 200438044, 200522012, 200610026 & 200610027. Under the IRS’s analysis in these rulings, if a trust is to distribute the assets <u>outright</u> to a beneficiary, then the only remainder beneficiaries that must be counted are the individuals that would receive those assets, <u>provided</u> those individuals are alive on the taxpayer’s death and they have already attained the required age to receive the assets outright. For more information on this “outright to now living persons” approach, see Natalie Choate, Life and Death Planning for Retirement Benefits, 6th Edition 2006, section 6.3.06. This ruling is not helpful to dynasty trusts or lifetime trusts with rights of withdrawal, as the beneficiary is never required to take outright ownership of the trust assets. It will be interesting to see if the IRS will continue to apply the analysis of these rulings. Until the IRS or Congress clarifies these rules, practitioners in this area must proceed very carefully.

D. Conduit Trusts

Fortunately, the regulations do set forth a type of safe harbor trust, a “conduit trust”, that has a beneficiary the IRS will treat as a Designated Beneficiary. A conduit trust requires the trustee to distribute all of the retirement account withdrawals to the beneficiary. See Exhibit B for sample language; also see PLR 200537044. However, the trustee may use conduit trust assets to pay expenses attributable to such assets. PLR 200620026. As the trust may not accumulate any assets withdrawn from the retirement account, the IRS allows the trust beneficiary to be treated as the oldest beneficiary of the retirement account. Treas. Reg. section 1.401(a)(9)-5, A-7(c)(3), Example 2. Care should be taken to draft the beneficiary designation appropriately when using conduit trusts. See Exhibit A for sample language. Although conduit trusts have the advantage of certainty as they are specifically described in the treasury regulations, they also have a major disadvantage. A conduit trust cannot withdraw retirement account proceeds and accumulate them inside of the trust. This is often contrary to the intent of the client, who may be using a trust to prevent the retirement account assets from being distributed to the beneficiary for one reason or another.

Conduit trusts are useful if the client wishes to defer a child's ability to withdraw more than the RMD until the child is older than 18 or 21 (Transfer to Minors Act custodianships must terminate at one of these ages). In this situation, an independent Trustee may be named with the authority to withdraw the greater of the RMD each year or an amount needed for the child's health, support and education. The child may be named to take over as sole Trustee at some age, or the independent Trustee may continue to serve for the child's lifetime.

E. Accumulation Trusts

A trust that allows accumulation of retirement account withdrawals (an "Accumulation Trust") may also qualify as a Designated Beneficiary. As noted above, the only guidance is this area is the outright to now living persons letter rulings. If a trust does not fit within such framework and is not a conduit trust, it is unclear how remote of a contingent beneficiary the IRS will take into account. To be safe, one must draft the trust assuming the IRS may take into account all contingent beneficiaries. Although this may be possible by adding certain savings clauses to the trust, there still is no specific guidance that this works. Obtaining a private letter ruling may provide certainty, but is expensive ($9,000 plus attorney fees) and time-consuming. It appears a private letter ruling may be granted while the account owner is still living or after the account owner's death. When drafting such an Accumulation Trust consider the following points.

First, only individuals may be beneficiaries of the trust (i.e. an estate, charity, business entity, or state, must be avoided). Second, to avoid an argument that the taxpayer's estate is a beneficiary of the trust, any debts, taxes or expenses payable from the trust cannot be paid after September 30th of the year after the calendar year of the taxpayer's death. Third, under no circumstances may an individual be a beneficiary who is older than the primary beneficiary whose life expectancy is used to calculate the RMD. Finally, the beneficiaries of the trust must be identifiable. For this purpose, if the remainder beneficiary involves a class capable of expansion or contraction, the beneficiaries will be treated as being identifiable if it is possible to identify the class member with the shortest life expectancy. Treas. Reg. section 1.401(a)(9)-4, A-1.

Accumulation Trusts require very careful drafting to ensure trust assets can never pass to an older sibling or relative, ever pass to an estate or charity, or ever escheat to the state. See Exhibit C for sample Accumulation Trust savings clauses. Most trusts fail these rules under the typical heirs-at-law contingent beneficiary clause that reverts to state intestacy laws if all of the primary family line die off. Under state intestacy laws, an older relative may inherit, and the property may escheat to the state. Trusts also typically provide that if a beneficiary dies without descendants, the trust property passes to the beneficiary's siblings (which may be older than the beneficiary). Powers of appointment also cause uncertainty in this area. See PLR 200235038 for power of appointment savings language. Assuming only individuals younger than the primary beneficiary are contingent beneficiaries, an attorney must still deal with the rule that all of the beneficiaries of the trust must be identifiable. This can be a significant hurdle when dealing with mulit-generation trusts.

F. Separate Accounts For Trusts

Treasury Regulation section 1.401(a)(9)-4, A-5(c) provides that the "the separate account rules under A-2 of section 1.401(a)(9)-8 are not available to beneficiaries of a trust with respect to the trust's interest in the employee's benefit." The IRS now takes the position that separate account treatment is not available when a single trust is named as beneficiary. See PLR 200432029. Under the IRS's interpretation, if all of the separate trusts created under a revocable trust are see-through trusts, then the RMDs of all such separate trusts will be based on the oldest beneficiary of any of the separate trusts, not the beneficiary of the trust at issue. Therefore, whenever possible, on the beneficiary designation form it is best to directly name the separate trusts to be created, as opposed to naming the funding trust. See PLR 200537044. For example, instead of naming the "John T. Smith Revocable Trust" as the beneficiary, consider the language on Exhibit A. Separate accounts for trusts is only an issue if each such separate trust is a see-through trust (a conduit trust or Accumulation Trust), otherwise the ages of the trust beneficiaries are irrelevant in determining the trust RMDs, and separate account treatment is not necessary.

G. Estate Taxes and Funding Credit Shelter Trusts

Retirement accounts are not only subject to income tax when distributed to the beneficiary, they are also subject to estate tax at the death of the owner. The combined impact of the estate tax, federal income tax, and a possible state income tax, can be debilitating, even though the estate taxes on the retirement account assets are deductible for income tax purposes. IRC section 691(c). This heavy tax burden makes tax-deferred retirement accounts the best source for charitable bequests at death, as charities are exempt from the income tax and the distribution to the charity at death qualifies for an estate tax charitable deduction.

Estate taxes may be payable from the taxpayer's probate estate, a trust, or may need to be paid by a withdrawal from the IRA. A client's estate planning documents should be drafted to ensure, to the extent possible, that any tax due is paid from non-retirement assets, as the withdrawal of retirement assets to pay taxes will cause additional income tax. Attorneys should pay close attention to the tax apportionment clauses in the wills and trusts of clients with large retirement accounts.

For estates that are subject to estate tax, one of the most troublesome areas is the use of retirement assets to fund a credit shelter trust. Many of the reasons to use a trust involve nontax issues, and these reasons may outweigh any possible income deferral possibilities. However, when dealing with funding a credit shelter trust, the choice is between deferring one tax and avoiding another tax. Often, an advisor must ask the client to choose between competing tax concerns. The uncertainty of the estate tax, combined with an increasing exemption, will often lose out to the more certain income tax hit of losing out on a spousal rollover and life expectancy payout option. There are five main reasons to avoid naming a credit shelter trust as beneficiary of a retirement account. If the credit shelter trust is the beneficiary: (i) distributions from the retirement account must begin sooner (the year after the taxpayer's death) than if the spouse was directly named beneficiary, if the surviving spouse is under age 70 ½, (ii) the RMDs are larger <u>during</u> the spouse's life – more must be distributed from the retirement account each year, (iii) the RMDs are larger <u>after</u> the spouse's death, (iv) the trust will often be in the highest income tax bracket, and (v) the use of trust assets to pay income taxes on the RMDs wastes estate tax exemption. There is no way to avoid all of these problems. Consider the following four options.

Option 1 – Conduit Trust
If a conduit credit shelter trust is named as the primary beneficiary of the retirement account, then the entire retirement account will be paid out over the spouse's life expectancy. This will save very few tax dollars, as the retirement account assets will be added to the spouse's estate just as if the spouse had been named directly as the beneficiary, but without the income tax advantages of the spousal rollover. A conduit trust is usually a poor alternative when dealing with funding a credit shelter trust.

Option 2 – Accumulation Trust
A better option is to name an Accumulation Trust as the primary beneficiary of the retirement account, preferably with a favorable IRS private letter ruling in hand. An Accumulation Trust allows the spouse to be treated as the Designated Beneficiary of the retirement plan. See PLR 200522012. Although the spousal rollover may not be available, a life expectancy pay-out option will allow distributions from the retirement account - and the associated income tax liability - to be gradually withdrawn over the spouse's life expectancy. The Accumulation Trust will usually be subject to income tax at the highest marginal rate. However, amounts distributed to the beneficiary are taxed at the beneficiary's presumably lower rate. The Accumulation Trust's advantage over the Conduit Trust is that the Accumulation Trust can retain distributions from the retirement account inside of the trust. In other words, the trust is not required to distribute the retirement account withdrawals directly to the spouse; they are accumulated inside of the trust until needed for the support of the spouse or children. The retirement account withdrawals not distributed from the trust will pass estate tax free to the next generation.

Option 3 – Spouse as Primary Beneficiary
Naming the spouse directly as the primary beneficiary is often the best solution. If the spouse will consume a substantial portion of the retirement account during the spouse's lifetime or the estate tax exemption is enough to shield all of the taxpayer's assets, then there may be no future estate tax to worry about. This option also has an advantage over the Accumulation Trust in that the spousal rollover may allow more income tax deferral and the spouse can name new beneficiaries that may use a life expectancy payout after the spouse's death. Obviously, the disadvantage to this option is that the retirement account cannot be used to fund the credit shelter trust and may cause a future estate tax if the assets are not consumed by the surviving spouse.

Consider including a disclaimer option on the beneficiary designation form to give the surviving spouse nine months after the account owner's death to weigh the estate tax advantages of funding the credit shelter trust against the income tax advantages of a rollover. PLR 200522012. See Exhibit D for sample language.

Option 4 – Traditional Credit Shelter Trust
If the account owner has already attained age 70 ½ and the owner's spouse is around the same age, then the RMD will be about the same whether or not the trust qualifies as a see-through trust. Also if it is expected that the spouse will <u>not</u> consume most of the retirement account before death (due to a short life expectancy or substantial other assets), then naming a traditional credit shelter trust (as opposed to a conduit trust or Accumulation Trust) as the primary beneficiary of the retirement account should be considered, as the estate tax savings may outweigh the lost income tax deferral.

V. Nontax Issues

It is often impossible to fit the necessary language on the beneficiary designation form itself. The best approach is to simply write the words "See Attachment" on the form and place all of the necessary language on an attachment that is submitted along with the preprinted signed form.

To ensure a beneficiary designation form is accepted by the IRA custodian or plan administrator, the attorney should always submit the forms to such parties with a receipt (including a complete copy of the signed form attached) that requires the custodian/administrator to sign and date a statement to the effect that the attached beneficiary designation forms were accepted and are now effective. If the attorney does not receive the receipt back, then a simple follow-up phone call can fix a problem, that if left until death, could be catastrophic to the estate plan.

Due to the complexity of this area of law and the ability of a stubborn IRA custodian to frustrate the income tax planning of a testator, an attorney should review the IRA agreement before deciding on a retirement planning course of action. To avoid problems after death, Ted Riseling and Jeff Rhodes, in their newsletter, *The Riseling Report*, suggest sending a letter to the IRA custodian during the client's lifetime asking for a <u>written</u> response to the following questions.

1. Do you honor the Designated Beneficiary rules, contained in treasury regulation section 1.401(a)(9)-4, A-5, when <u>a trust is named beneficiary</u> of an IRA and allow the beneficiaries of the trust to be considered Designated Beneficiaries of the IRA?

2. Do you permit the beneficiary of an IRA to make <u>investment</u> decisions concerning that beneficiary's portion of the IRA?

3. Will you permit the beneficiary of an IRA to name a <u>successor beneficiary</u> for any undistributed portion of the original beneficiary's share of the IRA?

4. Will you let the IRA beneficiary move the IRA to another IRA custodian after the account owner's death as permitted by Revenue Ruling 78-406?

5. If an IRA beneficiary elects the five year payout method, will you permit multiple withdrawals during the five year period?

6. If an IRA beneficiary elects to receive distributions over the beneficiary's lifetime, will you allow the beneficiary to take more than the required minimum distribution in any year?

7. If: (i) a trust is named as the beneficiary of the IRA, (ii) the trust qualifies as a beneficiary pursuant to the applicable treasury regulations, (iii) the trust agreement provides for separate shares to be created upon the account owner's death, and (iv) the beneficiaries comply with all other treasury regulations and other tax laws; will you permit the beneficiaries to split the IRA into multiple IRAs in accordance with the trust agreement so as to create separate shares consistent with the trust agreement?

8. Do you accept customized beneficiary designation forms?

Ted M. Riseling & Jeff K. Rhodes, *The Riseling Report*, January 2003, located at http://www.oktrustlaw.com/reports/JANUARY03.doc (for items 1-7). The questions above are not intended to be an exhaustive list and other questions may be appropriate depending upon the particular client situation. The taxpayer should consult with his or her attorney if the custodian's response to any of these questions is no.

VI. Conclusion

One of the most important areas of estate planning is dealing with tax-deferred retirement accounts. Unfortunately, this is an extremely complicated area of law. Becoming familiar with the issues discussed in this article is crucial for estate planning attorneys.

Attorneys should consider the following points when dealing with retirement accounts:

- Retirement accounts present unique problems as withdrawals after the owner's death trigger income taxes.

- Be mindful of the reasons when income tax deferral is not at issue.

- Consider making charitable gifts from retirement accounts to avoid income and estate taxes after the client's death (name the charity directly on the beneficiary designation form as to a fractional, not pecuniary, amount).

- Trusts should typically be avoided as beneficiaries, unless income tax deferral is not at issue.

- Draft tax apportionment clauses in wills and trusts to provide for estate tax payments from funds other than the retirement accounts, if other funds are available.

- Ensure beneficiary designation forms are drafted to create separate accounts when multiple beneficiaries are being named under a trust and a life expectancy payout option is desired.

- If there are substantial funds in an IRA, then make sure to ask the IRA custodian the questions above to avoid problems after the owner's death.

- Always obtain written documentation from the retirement account administrator confirming the beneficiary designation form was accepted.

EXHIBIT A
SAMPLE BENEFICIARY DESIGNATION
TO BE USED WITH CONDUIT TRUSTS

Attachment To Beneficiary Designation
For Account No: ____________

Primary beneficiary: My spouse.

Contingent beneficiaries: If my spouse does not survive me, then any amount on deposit at my death shall be divided into fractional shares so as to provide an undivided equal share for each of my children who is either living on my date of death or is deceased on my date of death but who has one or more descendants living on my date of death. Any share created for a deceased child of mine shall be divided into separate shares for such deceased child's descendants, per stirpes. Each share created above shall be owned by the "Separate Trust" created for such individual pursuant to Article 10 of the CLIENT NAME REVOCABLE TRUST dated ____________.

Each of the Trustees of the Separate Trusts designated above, shall have the right (with respect to the death benefits as to which that Separate Trust receives) to elect any method of payment available.

The assets of my account shall be segregated, effective as of my death, into separate subaccounts, one for the share representing each Separate Trust, so that all postdeath investment net earnings, gains, and losses are determined separately for each subaccount. The Trustees of each Separate Trust shall have the right to direct changes to investments held in such Separate Trust's separate subaccount.

Dated:

____
CLIENT NAME

EXHIBIT B
SAMPLE CONDUIT TRUST

ARTICLE 10. SEPARATE CONDUIT TRUSTS FOR RETIREMENT BENEFITS

Creation of Separate Trusts for My Descendants
The day the survivor of my spouse and I dies is hereinafter referred to as the "Allocation Date." The Trustees shall create one share for each of my children who is either living on the Allocation Date or who is deceased on the Allocation Date but who has one or more descendants who are then living. The Trustees shall divide any share created for a deceased child of mine into separate shares for such deceased child's descendants, per stirpes. As thus divided, the Trustees shall hold each share created under this Article as a separate trust ("Separate Trust") for the benefit of the person for whom the share was created and shall administer the Separate Trust as provided in this Article. The Trustees shall take all necessary steps to ensure each Separate Trust is treated as a "separate account", as that term is used in Treasury Regulation sections 1.401(a)(9)-8, A-2(a)(2) & A-3.

Debts, Taxes and Expenses
Notwithstanding anything herein to the contrary, the debts, taxes and expenses described in Article ___ [the standard payment of debts, taxes and expenses clause] may not be paid from any assets that are subject to the provisions of this Article 10, after September 30 of the year after the calendar year of the Allocation Date. Also, the Trustees may refrain from paying such debts, taxes or expenses from any retirement benefits that are subject to the terms of the trust (whether or not subject to the terms of this Article 10), in order to defer the payment of income taxes associated with withdrawals from such retirement benefits, and for such other reasons as the Trustees deem appropriate.

Interpretation and Limited Power of Amendment
The Trustees shall interpret the terms of this Article 10 so the minimum required distributions from each retirement plan payable to a Separate Trust may be calculated and paid to such trust over the life expectancy of the beneficiary of such Separate Trust. The Trustees shall have the power to amend the terms of this Trust Agreement to the minimum extent necessary to accomplish such purpose.

Withdrawal and Distribution of Retirement Plan Assets
The Trustees of each Separate Trust shall take whatever steps are required to assure that any interest such Separate Trust has in a retirement plan, to the extent not previously distributed, is (and will at all times remain) immediately distributable on demand to such Separate Trust. Accordingly, the Trustees shall retain the unrestricted power to accelerate any installment distributions elected under the minimum distribution rules or otherwise. The Trustees of the beneficiary's Separate Trust shall withdraw only the required minimum distribution from each retirement plan payable to such Separate Trust, unless more than the required minimum distribution is necessary for the support and maintenance in reasonable comfort, health, and education of the beneficiary.

The Trustees shall immediately distribute to the beneficiary all amounts received by the Separate Trust from any retirement plan, after reduction for any trust expenses properly allocable thereto; provided if the beneficiary is under any legal disability, then the Trustees may make such distribution to a legal guardian for the beneficiary. The Trustees may also distribute so much, none, or all of the net income and principal of the Separate Trust, to or for the use of the beneficiary, in such proportions, amounts and at such times as the Trustees, in the Trustees' discretion, may deem advisable to provide for the health, education, support, and maintenance of the beneficiary. [*For flexibility, this provision allows the trust's interest in the retirement plan to be distributed in-kind to the beneficiary*.]

EXHIBIT C
SAMPLE ACCUMULATION TRUST SAVINGS CLAUSES

BROAD SAVINGS CLAUSE

Notwithstanding anything herein to the contrary, only individuals (as such term is used in Treasury Regulation section 1.401(a)(9)-4, A-3) may be beneficiaries (as such term is used in Treasury Regulation section 1.401(a)(9)-5, A-7) of a Separate Trust. Furthermore, no person who is older than the Primary Beneficiary of a Separate Trust shall have any interest in such trust, whether contingent or otherwise. Any nonindividual or individual who is older than the Primary Beneficiary, who would (notwithstanding this provision) otherwise be a beneficiary of the trust, shall be treated as if such individual was then deceased, or such nonindividual did not then exist.

ESCHEAT TO THE STATE SAVINGS CLAUSE

If none of the persons named above survive the deceased Primary Beneficiary, then the Trustees shall divide and distribute the then remaining assets in such amounts to such persons as would have received the same under the laws of descent and distribution of the State of _________ then in force as if I had then died intestate, a resident of the State of ________, and possessed solely of such assets; provided however, if the deceased Primary Beneficiary's Separate Trust would otherwise escheat to the State of __________, then the assets of such Separate Trust shall instead be paid outright to an individual that is younger than the Primary Beneficiary, such individual to be selected in the sole and absolute discretion of the Trustees.

EXHIBIT D
SAMPLE DISCLAIMER TO CREDIT SHELTER TRUST BENEFICIARY DESIGNATION

Attachment To Beneficiary Designation
For Account No: ____________

Primary beneficiary: My spouse.

Contingent beneficiaries:

<u>If My Spouse Disclaims</u>
If my spouse survives me, then any amount on deposit at my death that my spouse disclaims shall be paid to the [credit shelter trust] created pursuant to Article ___ of the CLIENT NAME REVOCABLE TRUST dated ______________.

<u>If My Spouse Predeceases Me</u>
If my spouse does not survive me, then any amount on deposit at my death shall be divided to provide one equal share, as of my date of death, for each of my children who is either living on my date of death or is deceased on my date of death but who has one or more descendants living on my date of death. Any share created for a deceased child of mine shall be divided into separate shares for such deceased child's descendants, per stirpes. Each such share of my account created for a descendant of mine who has not attained the age of twenty-one (21) shall be held by _________________, as a custodian for the descendant under the [state of residency] Transfers to Minors Act or similar minor's custodian law of any state where the minor then resides.

Each of my beneficiaries designated above, shall have the right (with respect to the death benefits as to which that beneficiary is then the Designated Beneficiary) to elect any method of payment available.

The assets of my account shall be segregated, effective as of the date of my death, into separate subaccounts, one for the share representing each beneficiary, so that all postdeath investment gains, losses, contributions and forfeitures are determined separately for each subaccount. Each beneficiary shall have the right to direct changes to investments held in his or her separate subaccount.

Dated: _________________________

CLIENT NAME

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