ESTATE PLANNING TOOLS FOR RETIREMENT PLANS

By: Keith A. Herman
Greensfelder, Hemker & Gale, P.C.
10 S. Broadway, Ste 2000
St. Louis, MO 63112
(314) 241-9090
kh1@greensfelder.com

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Estate Planning Tools For Retirement Plans[1]

By Keith A. Herman
Greensfelder, Hemker & Gale, P.C.

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 and Roth 401(k)s are addressed in Sections III.D and III.E. This article does not address non-qualified retirement accounts, such as deferred compensation.

II. Retirement Accounts Present Unique Problems

In general, the receipt of inherited property is not subject to income tax. IRC section 102(a). 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 After a taxpayer's death, income tax will be due on the amount withdrawn from the taxpayer's retirement account. IRC section 402(a). 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? (See Rev. Rul. 2006-26)
- What is the most tax efficient source of payment for estate taxes on the retirement account?

[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.

Charitable IRA Rollovers

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 made no changes to the substance of the charitable IRA rollover rules, but extended the applicability of the law to gifts made in 2008 and 2009.

Update – On December 17, 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, And Job Creation Act of 2010, which made no changes to the substance of the charitable IRA rollover rules, but extended the applicability of the law to gifts made in 2011 and 2012.

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 Section III.F 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

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. Treas. Reg. section 1.401(a)(9)-5, A-5(a)(2).

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.

D. 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). See Exhibit E for information on converting to a Roth IRA. 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 generation-skipping transfer (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).

As Roth IRA distributions are not subject to income taxes, some commentators suggest that a Roth IRA is an excellent growth asset with which to fund a credit shelter trust. However, as discussed later, drafting the credit shelter trust to ensure you can use the spouse's life expectancy for the RMDs can be complicated.

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

E. Roth 401(k)s

Starting in 2006, taxpayers have the option of contributing to a Roth 401(k) or 403(b) if the taxpayer's employer has such a plan. IRC 402A. These are sometimes referred to as designated Roth accounts (DRACs). A DRAC is treated like a 401(k) (or 403(b)) except that contributions to the account are not excluded from gross income, and qualified distributions from the account are tax-free. For example, DRACs are subject to the same lifetime and post-death RMDs as 401(k)s. However, the lifetime RMDs can be stopped by rolling over the DRAC into a Roth IRA. Treas. Reg. section 1.401(k)-1(f)(3); Reg.

section 1.402A-1, A-5(a). The advice for naming beneficiaries of Roth IRAs, described above, also applies to DRACs.

F. Non-Spouse Rollovers

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 rollovers. See IRC Section 402(f).

G. Separate Accounts and Multiple Beneficiaries

If there are multiple beneficiaries of a retirement account, you are deemed to have no Designated Beneficiary, unless all of your beneficiaries are individuals. Treas. Reg. section 1.401(a)(9)-4, A-3. If all of the beneficiaries are individuals, 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).

However, 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 (and allows you to ignore a non-individual beneficiary of a different 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.

H. 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 (pursuant to a disclaimer that satisfies IRC section 2518), 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).

I. 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 share 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 <u>Conduit Trusts</u> Section herein.

J. 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. IRC Section 501(a).

K. 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

Due to the complexity associated with qualifying a trust as a Designated Beneficiary, a revocable trust should usually be avoided as the beneficiary of a retirement account. 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.

However, 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 could be a problem with multi-generation dynasty trusts (i.e. perpetuity trusts). However, the IRS has not used this requirement in any published rulings to disqualify a trust.

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 qualified terminable interest property (QTIP) trust or qualified subchapter S trust (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 which beneficiaries and under what circumstances they can be ignored.

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, irrespective of the identity of the remainder beneficiaries. 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.

Conduit trusts do not work in many situations where it is important for the Trustee to have the discretion to accumulate the retirement account withdrawals inside of the trust – such as when creditor protection is at issue. In these situations, an accumulation trust should be considered.

E. Accumulation Trusts

A trust that allows accumulation of retirement account withdrawals – any trust other than a conduit trust (referred to herein as an "Accumulation Trust") – may also qualify as a Designated Beneficiary. As noted above, the only clear rule in this area is the outright to now living persons approach in the letter rulings cited above. If a trust does not fit within such framework and is not a conduit trust, it is not entirely clear how remote of a contingent beneficiary the IRS will take into account. However, the letter rulings described below give some guidance on what should work.

PLR 200218039 (trust qualified as Accumulation Trust with no savings language)

In this PLR, the taxpayer named his revocable trust as the beneficiary of his IRA. The revocable trust created a family trust in which taxpayer's spouse received all of the income, and the spouse and descendants could receive distributions of principal according to an ascertainable standard. The trust, as modified by court order, provided that at the death of the spouse, the remaining assets would remain in trust for the children for their lives and ultimately be distributed to the grandchildren.

The IRS found that spouse was the oldest beneficiary and the trust could therefore use the spouse's life expectancy to calculate the RMDs.

PLR 200235038, 200235039, 200235040, 200235041 (ruling failed to address remainder beneficiaries)

In these identical PLRs, taxpayer named his revocable trust as the beneficiary of his IRA. The revocable trust divided into separate lifetime trusts for each of his three children. The terms of each lifetime trust provided that the child would receive all of the net income, and could receive principal for health, education, maintenance, and support. At the child's death, the remaining trust assets were to be distributed as the child may have appointed during life or at death among any persons or entities other than the child, the child's estate, the child's creditors, the creditors of the child's estate, or any "Disqualified Appointee." A Disqualified Appointee was defined as "(1) any individual born in a calendar year prior to the calendar year of birth of my oldest living issue at the time of my 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 my oldest living issue at the time of my death." The Trustee could not use the IRA proceeds to pay debts, administration expenses, or taxes of the estate. *The ruling did not state who were the default beneficiaries of the trust at the child's death, to the extent the child did not exercise the power of appointment*.

The IRS ruled that each of the three lifetime trusts qualified as "see-through" trusts (i.e. each trust met the four tests under Treas. Reg. section 1.401(a)(9)-4). The RMDs for each lifetime trust were to be based on the life expectancy of the oldest of the three children, because pursuant to the terms of the trust, "any potential beneficiary of [the child's] interest in IRA X must be no older than [the oldest child]." Each child's lifetime trust had to use oldest child's life expectancy to calculate the RMDs because the beneficiary designation did not name the three lifetime trusts directly – the IRA was payable to Revocable Trust, not the subtrusts created thereunder. Therefore, as explained in the next section, separate account treatment was not available.

PLR 200522012 (no savings clause – IRS only considered the first line contingent beneficiaries)

In PLR 200522012, taxpayer named his spouse as the primary beneficiary of his IRA. The beneficiary designation provided that any portion of the IRA the spouse disclaimed passed to a Marital Trust. Further, any portion of the IRA passing to the Marital Trust that spouse disclaimed passed to a Family Trust. Taxpayer died and spouse proposed to disclaim a portion of the IRA to the Family Trust. Under the terms of the Family Trust (as modified by a court order), spouse and taxpayer's issue could receive distributions of income and principal for health, support, maintenance, and education. Spouse had a testamentary power of appointment, but it was being disclaimed so that the disclaimer would qualify under IRC Section 2518 (disclaimed property must pass without any direction of the disclaimant). At spouse's death, the remaining Family Trust assets were to pass to taxpayer's two daughters by right of representation. *The ruling does not mention whether the daughters were to receive the remainder of the trust outright or in further trust.* The daughters were adults at the time of taxpayer's death. It was

represented that no debts, taxes, or expenses of taxpayer's estate were to be paid from the IRA.

The IRS ruled that the Family Trust qualified as a see-through trust and stated that all of the beneficiaries of the Family Trust must be considered for purposes of determining who, if anyone, is the designated beneficiary. The ruling determined that the only beneficiaries of the Family Trust were the spouse and two daughters. As the spouse was the oldest of the three beneficiaries, the RMDs from the Family Trust were to be based on spouse's life expectancy using the tables found in Treasury Regulation section 1.401(a)(9)-9 (see Exhibit G).

PLR 200537044 (savings clause allowed current beneficiaries to be treated as oldest beneficiaries)

In PLR 200537044, taxpayer named nine separate trusts, created under the terms of "Trust T", as beneficiaries of his IRA, each as to a specific percentage of the IRA. After the taxpayer's death a trust protector exercised his right to modify the terms of one of these trusts (Trust J) to transform the trust from a conduit trust to an accumulation trust. After the trust protector's modification of Trust J, the beneficiary (J) could receive income and principal for health, maintenance, support, and education. The beneficiary also had a testamentary limited power of appointment among any individual and/or charitable organization, other than the beneficiary's estate, creditors, and/or creditors of the beneficiary's estate. At the beneficiary's death, any unappointed assets were to pass to the other remaining eight separate trusts in proportion to their relative percentages. If no such trusts were in existence, the remaining assets were to pass to the taxpayer's "heirs at law."

The trust protector provisions provided "that if a separate trust established under the provisions of Trust T provides for the discretionary distribution of accumulated income and/or principal to someone other than the primary beneficiary or for a power of appointment over accumulated income and/or principal to someone other than the primary beneficiary, the Trust Protector may add to such provision that no such accumulated income and/or principal shall be paid to or for the benefit of: (1) any person who is older than the primary beneficiary of such trust."

Within nine months of taxpayer's death, the trust protector exercised his right to "(1) convert J Trust (set up to benefit J) to an Accumulation Trust and (2) to limit potential remaindermen of J Trust to persons not older than J." Presumably, this also removed charities from the class under the beneficiary's power of appointment.

The IRS ruled that Trust J qualified as a see-through trust. As "none of the remaindermen of said trust can be older than J", the RMDs for Trust J would be based on J's life expectancy.

PLR 200608032 (savings clause allowed IRS to ignore contingent remainder beneficiaries)

In PLR 200608032, the account owner named his trust as the primary beneficiary of his IRA. The account owner was survived by 6 children – B, C, D, E, F, and G. The trust provided for certain distributions to charities and the remainder was divided equally among the six children. Each child received his share outright, except for G.

After being modified by court order after the account owner's death, the trust provided that: (1) the trustee may not distribute any portion of the IRA to or for the benefit of the decedent's estate, any charity, or any non-individual beneficiary, after September 30 of the year following the year of the decedent's death, (2) after September 30 of the year following the year of the decedent's death, the IRA may not be used for payment of the decedent's debts, taxes, expenses of administration or other claims against decedent's estate, nor for the payment of transfer taxes due on account of decedent's death, (3) the income and principal may be distributed for G's education, health, maintenance, comfort, and general welfare, (4) At G's death, the remaining assets pass to G's descendants, or if none to G's spouse, and if G's spouse is not living, then any remaining portion of the IRA may not be paid to any non-individual beneficiary or to any individual older than the oldest of the six children.

The IRS found that the RMDs from the trust for G could be paid out using the life expectancy of the oldest of the six children.

Which Beneficiaries Can Be Ignored?

The rulings described above clearly show that the IRS is willing to ignore certain contingent remainder beneficiaries of a trust. The rulings also provide us with helpful savings language. The important point to take away is that in none of these ruling did the IRS pay attention to any contingent beneficiaries other than those that were living at the taxpayer's death. For example, if the trust is payable to spouse with the remainder to spouse's children that are alive at the spouse's death, then the IRS is only taking into account the children, provided they are living at the taxpayer's death. The IRS has not engaged in any analysis of what would happen if the children predeceased their mother and who the next line beneficiaries would be. However, the IRS has a history of suddenly changing their letter ruling provision on certain issues. Therefore, it is best to plan for the IRS becoming more aggressive in this area by using a savings clause (the most conservative approach is to use a conduit trust).

In PLR 200537044 the IRS approved of a trust with the following savings language:

> no such accumulated income and/or principal shall be paid to or for the benefit of . . . any person who is older than the primary beneficiary of such trust.

This language did not preclude a non-individual from being a beneficiary of the trust.

The trust in PLRs 200235038 to 200235041 covered both categories of unwanted trust beneficiaries – older beneficiaries and non-individuals. However, these rulings only excluded these unwanted beneficiaries from the scope of the testamentary power of appointment. The savings language did not apply to the default trust contingent beneficiaries that would take upon a failure to fully exercise the power of appointment. The following were disqualified as beneficiaries under the power of appointment: "(1) any individual born in a calendar year prior to the calendar year of birth of my oldest living issue at the time of my 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 my oldest living issue at the time of my death."

Accumulation Trust Drafting Suggestions

If you choose to venture in the world of Accumulation Trusts, 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, you must exclude as beneficiaries individuals older than the primary beneficiary whose life expectancy is used to calculate the RMDs.

See Exhibit C for sample Accumulation Trust savings clauses.

It is best to segregate the interest in the retirement account payable to a trust from the other trust assets by using a separate trust. This helps in limiting the scope of the savings language to only the retirement account assets.

Changing the Terms of the Trust After the Account Owner's Death

PLR 201021038 seems to represent the IRS's current position on modifying a trust after the taxpayer's death.

PLR 201021038 (modification of trust by court order after death was not respected)

In PLR 201021038, husband and wife created a joint revocable trust. At the first spouse's death, a portion of the trust assets passed to a credit shelter trust. The surviving spouse named the credit shelter trust as the beneficiary of his IRA and subsequently died. The remaining assets of the credit shelter trust, after certain specific bequests were paid (the ruling does not describe the beneficiaries of the specific bequests), were to be divided into lifetime trusts for the spouse's children. The terms of each lifetime trust provided that the child could receive income and principal for health care, maintenance, support, and education. If an Independent Trustee was appointed, then distributions could also be made to the child's descendants. Each child also had a lifetime power to appoint the assets of the child's lifetime trust to certain persons and entities, including charities.

The lifetime trusts were modified by court order after surviving spouse's death, in order to qualify them as conduit trusts and remove charities as potential appointees. The IRS

stated that the modification did not apply retroactively to the surviving spouse's date of death, as a judicial reformation of a trust "is not effective to change the tax consequences of a completed transaction," unless the reformation is specifically authorized by the Internal Revenue Code (such as in the case of charitable remainder trusts).

As charities were among the class under the lifetime powers of appointment, the ruling determined that the lifetime trusts were not designated beneficiaries and the RMDs for each trust were to be based on surviving spouse's remaining life expectancy (she died after age 70 ½).

PLR 201021038 is a change from the IRS's former position. In prior retirement account rulings, the IRS respected court modifications of a trust after the account owner's death for income tax purposes with no analysis of this issue. See PLR 200620026 (trust modified by court order to become a conduit trust); PLR 200608032 (trust modified by court order to become a valid Accumulation Trust); PLR 200218039 (trust modified by court order to become a valid Accumulation Trust); PLR 200522012 (trust modified by court order to become a valid Accumulation Trust).

In PLR 200742026, the IRS refused to be bound by a court sanctioned modification of a taxpayer's beneficiary designation almost two years after the taxpayer's death. The account owner died with no living beneficiary; therefore the IRA was payable to the owner's estate. The owner's only child tried to have the beneficiary designation modified retroactive to date of death to name the child directly on the form. The IRS pointed out that after the taxpayer's death you can only remove existing beneficiaries, not add new ones. And even then, it must be done prior to September 30 of the year after the calendar year of the taxpayer's death.

The regulations specifically provide that, with respect to retirement accounts payable to a trust, you can remove certain beneficiaries (but not add beneficiaries) after the taxpayer's death by: (1) the Trustee distributing to a beneficiary everything the beneficiary is entitled to under the terms of the trust or (2) a beneficiary disclaiming his/her interest in the trust within 9 month's of the taxpayer's death with a disclaimer that meets the requirements of IRC Section 2518. Both of these must be accomplished prior to September 30 of the year after the year of the taxpayer's death. Treas. Reg. section 1.401(a)(9)-4, A-4(a). The regulations do not specifically prohibit other ways of removing the beneficiaries after the taxpayer's death.

The analysis in PLR 201021038 is questionable. A good argument can be made that September 30 of the year after the taxpayer's death is the date of the taxable event that is at issue. The IRS generally respects court modifications that occur before the taxable event. Rev. Rul. 73-142. If a trust is modified after a taxpayer's death but prior to September 30 of the year after the year of the taxpayer's death, then the modification should be respected if all it does is remove existing beneficiaries (as opposed to adding beneficiaries).

In PLR 200537044 (described above) the IRS allowed a "trust protector" to amend the terms of a trust after the taxpayer's death, only after the trust protector represented that the modification was done within 9 month's of the taxpayer's death and that the modification was "treated as a disclaimer" under state law. The IRS also pointed out that under the terms of the trust, the trust protector's modification of the trust was effective "ab initio" and related back to the date the taxpayer's died. It is hard to understand how a fiduciary's modification of the trust could be treated as a disclaimer under state law when the beneficiary had no control over the modification. Maybe they were taking the position that the trust protector had the authority under state law to disclaim on behalf of the beneficiary. The attorney that represented the taxpayer in this ruling has indicated that after the trust protector modified the trust, the trust protector then renounced the right make future modifications. The attorney indicated that they represented to the IRS that *the trust protector's renunciation* was treated in the same was a "disclaimer" under state law (California). He says that it was never asserted that the trust protector's exercise of his powers was treated as a disclaimer. Philip J. Kavesh, PLR 200537044: Defective or Just Misunderstood (www.ultimateestateplanner.com/files/PLReffectmisunder.pdf).

You may be able to obtain a similar result – converting a conduit trust to an Accumulation Trust after the account owner's death – by actually using a disclaimer. The beneficiary could disclaim his/her mandatory right to receive all of the retirement plan withdrawals, but retain the ability to receive income and principal for an ascertainable standard. The original conduit trust would have savings language prohibiting non-individual beneficiaries and beneficiaries older than the primary beneficiary.

The bottom line is that it is best not to rely on being able to change the terms of a trust after your client dies – whether by a disclaimer, a trust protector, or a modification of the trust by court order or agreement of the beneficiaries. Put the right terms in the trust at the beginning.

Dealing with the IRA Custodian

The issue is most likely to come up when the account owner dies and you are working with the IRA custodian. If the account is a 401(k) or another type of qualified plan, then the administrator must see that the RMDs are paid appropriately or the entire plan could be disqualified. However, most qualified plans will not allow a life expectancy payout and the beneficiary will likely do a non-spouse roll-over to an IRA. IRA providers do not have this issue and are not required to calculate the RMDs for the account owner's beneficiaries. Section III of IRS Notice 2002-27 provides that an IRA custodian has no requirement to report the RMDs for beneficiaries of IRAs of deceased owners. However, many IRA providers calculate the RMDs as a service to the customer and therefore may have a duty to see that that they are calculated correctly.

Due to this confusing area of law in which we are primarily relying on private letter rulings, some IRA custodians may provide resistance to a trust being treated as a see-through trust and using a particular beneficiary as the measuring life for RMD purposes. In this situation you can offer to provide them with a legal opinion, or your best bet may be to move the account to an IRA custodian that is more willing to work with you. The

important point is that you need to explain the risks, and potential costs, to your client before drafting an Accumulation Trust that may be expensive to implement due to overly cautious IRA custodians.

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. PLR 200235038. 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 are 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. 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. In this case, it is not important for the trust to qualify as a conduit trust or Accumulation Trust and you can draft the trust based on other concerns.

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 written 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 a trust is named beneficiary 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 investment decisions concerning that beneficiary's portion of the IRA?

3. Will you permit the beneficiary of an IRA to name a successor beneficiary 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
This Article 10 shall only be effective if retirement benefits are payable to the Separate Trusts created under this Article 10 at my death. The date of my death 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 purpose of this Article 10 is to qualify all retirement benefits, that allow a life expectancy payout option, under the so-called IRC Section 401(a)(9) look through rules, so that the minimum required distributions from such retirement benefits may be calculated and paid to each Separate Trust over the life expectancy of the beneficiary of such Separate Trust. Prior to nine months after my death, the Trustees shall have the power to amend the terms of this Trust Agreement to the minimum extent necessary to accomplish such purpose. Any such amendment shall be effective ab initio, retroactive to the date of my death.

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 with respect to the Separate Trust's interest in any tax deferred retirement benefits subject to the "minimum distribution rules" of Code section 401(a)(9) or equivalent rules under any other Code section ("Retirement Benefits") and all assets derived therefrom. Furthermore, no person who is older than the Primary Beneficiary of a Separate Trust shall be a beneficiary with respect to the Separate Trust's interest in any Retirement Benefits and all assets derived therefrom. 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.

Notwithstanding anything herein to the contrary, upon the Primary Beneficiary's death, the Separate Trust's interest in all Retirement Benefits and all assets derived therefrom, may not be payable, whether outright, in trust, or pursuant to the exercise of a power of appointment, to (1) any individual older than the Primary Beneficiary, (2) any person other than a trust or an individual, or (3) any trust that may have as a beneficiary a person other than an individual or an individual who is older than the Primary Beneficiary. Any beneficiary who is disqualified as a beneficiary pursuant to the preceding sentence shall be treated as if such beneficiary was then deceased, or did not then exist.

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 Retirement Benefits after September 30 of the year after the calendar year of my death.

Interpretation and Limited Power of Amendment
The Trustees shall interpret the terms of each Separate Trust so the minimum required distributions from all Retirement Benefits payable to a Separate Trust may be calculated and paid to such trust over the life expectancy of the Primary Beneficiary of such Separate Trust. Prior to nine months after my death, the Trustees shall have the power to amend the terms of this Trust Agreement to the minimum extent necessary to accomplish such purpose. Any such amendment shall be effective ab initio, retroactive to the date of my death.

EXHIBIT D
SAMPLE DISCLAIMER TO CREDIT SHELTER TRUST BENEFICIARY DESIGNATION

Attachment To Beneficiary Designation
For Account No: ____________

Primary beneficiary: My spouse.

Contingent beneficiaries:

If My Spouse Disclaims
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 _____________.

If My Spouse Predeceases Me
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

EXHIBIT E
CONVERTING TO A ROTH IRA
(SAMPLE CLIENT MEMO)

Background. Beginning in 2010, there is no longer an income limitation on converting a traditional IRA to a Roth IRA. Converting to a Roth IRA will trigger additional income tax. The amount of the tax is equal to the fair market value of your IRA on the date of conversion less any nondeductible contributions. For conversions made in 2010 *only*, you could split the income and include half on each of your 2011 and 2012 income tax returns.

Distributions from the new Roth IRA will be income tax free, subject to the five year rule described below. By converting to a Roth IRA you are essentially prepaying the income taxes that would otherwise be due when withdrawals are made from the account (withdrawals are required after age 70 1/2, which are referred to as the required minimum distributions (RMDs)).

Benefits of a Conversion. At first glance, whether to convert would seem to be a simple question. If you expect to be in a higher tax bracket in the future, convert to a Roth and prepay the income taxes at the current lower rate. If you expect to be in a lower tax bracket during retirement, stick with the traditional IRA. However, Roth IRAs have two advantages over traditional IRAs that can make it worthwhile to convert even if you expect your tax rates to fall during retirement. First, to the extent you can pay the income taxes on the conversion from taxable assets (not an IRA or other retirement account), then you can shift more wealth to an income tax-free savings vehicle. Second, Roth IRAs do not have RMDs so Roth IRAs can grow income tax-free for a longer time.

Both of these advantages are due to the fact that both traditional and Roth IRAs are income tax exempt vehicles (for traditional IRAs income taxes are only deferred; taxes will eventually be due when distributions are made to the owner or beneficiary). You do not have to immediately pay income taxes on the earnings (interest, dividends, capital gains, etc.) inside these accounts, so the more money you can accumulate in them and the longer you can keep the money in them, the greater the benefit to you or your family.

The Perfect Situation. The one situation in which it will almost always make sense to convert is if (i) you can pay the income taxes on the conversion from non-retirement account assets, (ii) you will never need to take a distribution from the Roth IRA for living expenses or any other reason, (iii) you are leaving the IRA to individual beneficiaries whom you expect to stretch out distributions over the beneficiary's life expectancy, and (iv) you have significant enough family wealth that you expect to be paying estate taxes and you do not expect your income tax rate during retirement to decline.

Recharacterizing. The tax laws also allow you to undo a conversion by "recharacterizing" the Roth IRA back to a traditional IRA. A recharachterization must be done on or before the due date (including extensions) for filing the your Federal income tax return for the taxable year in which the conversion was made. Treas. Reg. Section 1.408A-5, Q&A-6(b). In most cases, this will be October 15 of the year following the conversion – the extended due date for income tax returns. For conversion made in 2011, the recharacterization deadline is October 17, 2012, as October 15 is a Saturday. If the value of your Roth IRA has significantly declined between the date of conversion and the October 15/17 deadline, it may make sense to recharacterize and then convert again the following year at a lower tax cost (a recharacterization cannot be reconverted in the same tax year as the original conversion and also cannot be reconverted within 30 days of the recharacterization).

Your Age. In general, the younger you are the more likely converting to a Roth IRA will be beneficial, as there will be more time to reap the benefits of tax-free growth inside the Roth IRA. However, if you fall into the "Perfect Situation" category above and will never need to take a distribution from the IRA, then your analysis should be whether the Roth IRA conversion is beneficial to your family (or the beneficiaries of your estate plan). If you convert to a Roth IRA today and pass away tomorrow, there could still be a large benefit to your descendants if they stretch out the distributions over their life expectancies.

Estate Taxes. You may wonder how this analysis changes if you expect to be paying estate taxes. In 2011 the gift/estate tax exemption is $5,000,000 per person with a tax rate of 35%. The income taxes paid on converting to a Roth IRA reduces the size of your estate that will be subject to estate tax. If you do not convert there is an income tax deduction for the estate taxes paid on IRA assets. The beneficiaries of the IRA will use a portion of the deduction each year they take a withdrawal from the IRA until the total deduction is used up. This will offset the double taxation of the IRA, *except to the extent* there is also a state estate tax, as there is no federal deduction for *state* estate taxes paid. Due to state estate taxes, you may be better off converting to a Roth IRA if you expect to be paying estate taxes.

Five Year Rules. Only distributions of your contributions (not the earnings on the contributions) are tax-free during the five-year period beginning on January 1 of the first year you open *any* Roth IRA. If your Roth IRA conversion in 2011 is your first Roth IRA, then distributions of "earnings" (interest, dividends, or gain earned after the conversion) will not be tax free until after 2015. If you are under 59 ½ at the time of the distribution, then there will also be a 10% penalty on any distribution of earnings during the five year period.

A separate five-year rule applies specifically with respect to a conversion to a Roth IRA. If a distribution is made to you within five years of the year of the conversion, then the 10% penalty will apply even if the distribution is not subject to income tax (i.e. even if you are not distributing any earnings), unless you are over age 59 ½ at the time of the distribution. For example, if you are 50 years old, convert to a Roth IRA, and pay the taxes out of the converted Roth IRA, then you will owe a 10% penalty on the amount used to pay the tax (it is considered a deemed distribution to you). This five year rule applies separately for every year in which a Roth IRA conversion occurs.

Complicated Fact-Sensitive Investment Decision. Deciding whether a Roth IRA conversion makes sense should be made with the joint input of your financial advisor, accountant, and estate planning attorney. However, this is primarily an investment decision. Preferably, your financial advisor can "run the numbers" and forecast the expected advantage or disadvantage to the conversion by making certain spending, tax rate, and other assumptions.

With the currently low income tax rates, converting to a Roth IRA in 2011 may be a valuable opportunity. The ability to "undo" it all next year with a recharacterization makes it even more enticing. However, there are significant traps for the unwary in making this decision.

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