

When Retirement Benefits Meet Trusts

Trust Planning, Drafting, and Administration under
Post-SECURE RMD Rules

*Includes Fiduciary Income Tax & Trust Accounting aspects
Illustrated with Case Studies*

Natalie B. Choate, JD
For Leimberg Information Services

Trust is named as beneficiary of an IRA or other retirement account

Trustee must deal with multiple legal systems:

- Applicable state laws regarding **trust accounting**: Trust says (e.g.) “Pay income to my spouse.” What is “trust income” with reference to an IRA?
- **Federal income tax**: An IRA consists of all or mostly “pretax income.” When is this income taxable and to whom? Meet “DNI”!
- **RMD rules**: When is the trustee REQUIRED to withdraw HOW MUCH from the IRA?

Trust named as IRA Beneficiary

What is/are the Trustee's job(s)?

- Determine RMD requirements
- Determine whether any post-death changes (disclaimer, reformation, distribution) are needed to improve RMD or tax results
- Plan how the RMDs will interplay with the trust's purpose (e.g. dynasty benefits? Support/education of beneficiary(ies)?)
- Comply with RMDs and pay applicable taxes

What you need to know

We start with a quick review of RMD basics you already know, then....

- How do those RMD rules apply to a trust?
 - ▶ E.g. when does a “trust for the spouse” get the same RMD deal as the spouse individually gets?
 - ▶ What trusts qualify for the 10-year rule?
- How does “trust accounting” fit in---e.g. “Income to spouse”---does “income” = RMD?
- What is the federal income tax treatment of distributions from IRA to trust to beneficiary?

Review: Post-SECURE RMDs

Payout period for post-death RMDs depends on whether the beneficiary is a:

- Designated beneficiary (DB)...a plain old DB (PODB) gets the “10-year rule”
- ELIGIBLE designated beneficiary (EDB)--5 types of EDBs get various “life expectancy payout” deals...or
- Non-designated beneficiary (NonDB) gets 5-year rule or “ghost life expectancy”

RMDs differ depending whether...

Participant died before or after “Required Beginning Date”

- **RBD** = generally, April 1 of year after year participant reaches age 73 (born after 1950) or 72 (born 7/1/49-12/31/50) or 70½ (born before 7/1/49); but...
- RBD is (if later) 4/1 of year after year of retirement for “non-5% owner” employees in qualified plans; and...
- There is NO RBD for Roth IRAs!

RBD Example

Shirley is working full time in her business (she owns 90%) and as a professor at a nonprofit college when she dies 2/1/2023 at age 75. She owns a traditional IRA and a Roth IRA and has a 401(k) account at her business and a 403(b) account at the college.

- She died **AFTER** her RBD for the traditional IRA and the 401(k)
- She died **BEFORE** her RBD for the Roth IRA and the 403(b)
- Isn't this fun?

Payout period for PODB

Plain old designated beneficiary gets the 10-year rule

- Participant (“P”) died before RBD: No RMD for year of death, no RMD for years 1-9 after death, 100% RMD in 10th year (year that contains 10th anniversary of death)
- P died after RBD: Bene must take RMD for year of death (if P didn’t take it in full), annual RMDs based on PODB’s life expectancy in years 1- 9, 100% RMD in 10th year.

Who are PODBs?

Any individual who is named as beneficiary by the participant but who is not an EDB

- Example: Parent dies, leaving his IRA to his adult nondisabled child as named beneficiary on Parent's beneficiary designation form.
- Child is an individual, and is a designated beneficiary (named on the BDF) but she is not an EDB so she is a PODB.

Who are “EDBs?”

5 Types of Individual Beneficiaries are EDBs

- Participant’s surviving spouse
- A minor child [under age 21] of participant
- A disabled or chronically ill (D/CI) individual
- Any individual who is none of the above and is not more than 10 years younger than participant (NoMoTTY)
- Status determined as of P’s date of death

Payout period for EDB

Annual instalments over EDB's life expectancy, with variations:

- EDB can (if allowed by plan) elect 10-year rule instead (death before RBD only)
- Spouse's life expectancy is "recalculated annually"; other EDBs use "fixed term"
- Minor child of participant: Life expectancy payout until 10th year after attaining age 21 (or earlier death); 100% payout in that 10th year. So "LE payout" is until age 31, not for "life"

Payout period for a Non-DB

Participant's estate; charity; nonqualifying trust

- P died before RBD: **5-year rule**. Entire plan balance must be distributed by 12/31 of year that contains 5th anniversary of death (or 6th anniversary if one of the 5 years was 2020). No RMDs until final year (then 100%).
- P died after RBD: Balance of year of death RMD, then over remaining years of Participant's life expectancy (the "**ghost life expectancy**")

What's wrong with this picture?

Death *after RBD* can produce “opposite” results....

- If P dies after RBD, & EDB is 82 or older, the PODB's 10-year rule would be a better deal than EDB's life expectancy deal (9.9 years)!
- ...and the “ghost life expectancy” deal (for a Non-DB) would be a better deal than the 10-year rule (for PODB) if the participant died before age 82!
- “Toggle” idea: Should you disqualify your own trust?

Realistic goals for trust RMD deals

Best deal *most* trusts can hope for: a 5- to 10-year payout

- 5-11 year payout (if there is “no DB” and participant dies before 81)
- 10-year payout for a POODB
- Longer payout if left to a young [under 80] spouse or D/CI beneficiary (much longer if spouse or D/CI bene is very young)
- Longer payout in rare/unusual cases: participant dies leaving benefits to his/her very young child; young participant dies leaving to a young NoMoTTY beneficiary

You need to know the RMD deal applicable to the trust you are drafting or administering

- Does the trust qualify as a “DB?”
- If so, and the trust has one or more EDBs as beneficiary(ies), does the trust get a life expectancy payout? If so whose LE?
- Does the trust get the 10-year rule?
- We will answer these questions in Part 1...

Part 1 covers:

One single trust is named as beneficiary. No changes are made after participant's death.

- There are no “subtrusts,” no disclaimers, no reformations.
- In Part 2 we will get to post-death changes such as disclaimers; in Part 3 multiple trusts and subtrusts.
- Let's go!

The post-death payout rules are based on two things:

“Who is the beneficiary” and “Did death occur before or after the RBD?”

- Is there a “designated beneficiary?” If not, we go directly to the “no DB” payout rules.
- If there is a DB, is he/she a PODB or an EDB?
- If an EDB, what *kind* of EDB? And,
- Did death occur before or on/after the RBD?

Definition of “Designated Beneficiary”

Code section 401(a)(9)(E)(i)

- “(i) Designated beneficiary. The term ‘designated beneficiary’ means **any individual designated as a beneficiary by the employee.**”
- Note: A designated beneficiary is an **INDIVIDUAL**. Not an estate. Not a charity. Not a corporation. **NOT A TRUST.**

How can a trust be a “DB”?

Regulations: How to “look through” the trust and treat the *trust beneficiaries* as if they had been named directly,

- Existing reg.: Since 2001-2002. Simple but vague: Pass 4 “trust rules,” list every possible beneficiary, then disregard “mere potential successors.”
- New Prop. Reg.: 4 step process tells you which *potential* trust beneficiaries are **countable**, with 10 specific “disregard” rules
- New process much more clear.... and generous.

4 steps to determine trust's countable beneficiaries

When you know the countable beneficiaries [my term] you will know the trust's payout period

- Step 1: Does the trust pass the 4 trust rules?
- Step 2: List all *potential* beneficiaries. There are 7 “disregard” rules applied when making this list!
- Step 3: Divide your potential beneficiaries into “first tier” and “second tier”
- Step 4: Apply the final 3 disregard rules to arrive at the *countable* beneficiaries

Step 1: The 4 trust rules

Unchanged from existing reg., except #4 below is now more generously interpreted

- Trust must be valid under state law
- Trust must be irrevocable as of participant's death
- Copy of trust must be given to plan administrator by 10/31 of year after death
- All beneficiaries must be "identifiable"

More detail on the 4 trust rules

Valid under state law; Irrevocable as of date of death; copy to plan administrator

- No examples yet of trust not valid
- Don't forget providing copy of trust to plan administrator. Don't plan to use this rule as a "toggle!"
- Irrevocability rule creates issues if decedent left IRA to surviving spouse's revocable trust...So don't do that.

Meaning of “identifiable”

The meaning is changed from the old regs

- Under existing regs. “Identifiable” meant you could identify the oldest possible beneficiary
- Under proposed regs, it just means you can identify the beneficiaries who will or might inherit the retirement benefits
- **NEW**: The proposed regs clarify what this means with respect to powers of appointment and other potential post-death changes.

Step 1: Review

What happens if you flunk Step 1....

- Passing “Step 1” gets you into the building. It’s like filling in your name & address on a test.
- If the trust “flunks” Step 1 (e.g. you forgot to give a copy of trust to plan administrator), you’re done. Your trust beneficiaries can NOT qualify as designated beneficiaries...
- ... and you have a Non-DB. Skip Steps 2-4, go directly to Step 5.

Step 1, continued:

If you PASS Step 1 (comply with the 4 trust rules), then...

- Congratulations! You have a “see-through trust”! But don’t get too excited...
- Passing the 4 rules does not mean you have a “designated beneficiary”
- It just means you are “in the door” and now have **permission to look through the trust** and test the trust beneficiaries to see whether they are “DBs”

Step 2: List all potential beneficiaries

List every person or entity who could ever possibly inherit the benefits (or proceeds thereof) through this trust.

- There are 7 “disregard rules” applied in this step...people/entities who are “disregarded” in determining your potential beneficiaries
- 4 of those disregard rules deal with post-death changes.
- So for now: We will assume no post-death changes and look at only **3 disregard rules:**

Disregard predeceased people

A named beneficiary who died before the participant is not a potential beneficiary

- Example: “Income to my spouse Mary for life, remainder to my issue who survive Mary and me, per stirpes. If no issue survive us, then to Charity X.”
- Mary dies before the participant.
- Mary is not a potential beneficiary. The potential beneficiaries are participant’s issue living at participant’s death and Charity X.

Disregard beneficiaries who don't exist yet

Future issue do NOT get listed. NO!!! Don't do it!!!!

- Trust says “income to my son for life, remainder to his issue living at his death, or if there are none, to Charity X.”
- When participant dies, son has no living issue. The listable or potential beneficiaries are son and Charity X.
- **This requirement is not stated in the Proposed Regulations. It is just obvious!**

Disregard people who don't exist

Example in case you don't believe me...

- Trust: “Income to Aunt Jane for life, remainder to her issue per stirpes, or if she has no issue then living, to Charity X.”
- Jane is 84 with no living issue. ∴ Potential beneficiaries are Jane & Charity X.
- But Jane COULD have issue! She COULD adopt for example! Why can't we count her potential issue so we have all individual benes?

Beneficiaries who don't exist yet, cont.

Perpetuities trusts: The fact that the trust is SUPPOSED to continue for P's issue in perpetuity is irrelevant

- Trust says, "Use income and principal for the benefit of my issue living from time to time forever. If at any time I have no issue living, pay to Charity X."
- Participant dies with 3 living children and 4 living grandchildren.
- Potential beneficiaries are 3 children, 4 GC, and Charity X.

NEW:

Disregard potential appointees

Appointees under a power of appointment are not listed as potential beneficiaries until the power is exercised

- Trust says “Income to my spouse for life, on spouse’s death pay principal to such charity or individuals as my spouse shall appoint by will, or, in default of appointment, pay to my issue then living.”
- Even though spouse COULD appoint to charity (a nonindividual), the charity is not listable as a potential beneficiary unless and until spouse exercises the power.

Powers of appointment, cont.

Takers in default are the “potential beneficiaries” until power is exercised

- Spouse has power to appoint by will. Such a “testamentary power” cannot be exercised until death. Merely signing a will is not effective; exercise becomes effective when she dies.
- Until such time as she does exercise the power, the takers in default (participant’s issue in this example) are your “listable” (potential) beneficiaries.

You have completed Step 2

You're halfway through the testing process!

- You have listed all now-living people and entities that might possibly receive retirement benefits (or proceeds thereof) through this trust. This is your list of “potential” beneficiaries.
- You have excluded the predeceased, the not yet existing, and those who would inherit only if a power of appointment is exercised in the future.

Step 3: Divide potential beneficiaries into first tier and second tier

This can be difficult

- Extremely important step because
- All “first tier” beneficiaries are “countable.”
- Some “second tier” beneficiaries are “disregardable” under 3 rules in Step 4.
- If you want to have a DESIGNATED BENEFICIARY all your countable beneficiaries must be individuals.

Step 3: Divide potential beneficiaries into first tier and second tier, cont.

These are my definitions

- A first tier beneficiary is any potential beneficiary who will be entitled or eligible to receive benefits after the Participant's death, *without having to wait for someone else to die.*
- A second tier beneficiary is any potential beneficiary who might receive benefits after the death of a/the first tier beneficiary(ies)...i.e. *must wait until someone else dies.*

Step 3, cont: IRS definition

IRS's definition of what I call "first tier" beneficiaries.

Note: IRS does not use the term "first tier" beneficiary.

- "Any beneficiary who could receive amounts in the trust representing the employee's interest in the plan that are neither contingent upon, nor delayed until, the death of another trust beneficiary who did not predecease (and is not treated as having predeceased) the employee." Prop. Reg. § 1.401(a)(9)-4(f)(3)(i)(A).

Step 3, cont.

More proposed regulations definitions...

- Another IRS definition of what I call first tier beneficiaries: “beneficiaries described in paragraph 1.401(a)(9)-4(f)(3)(i)(A).”
- IRS definition of what I call second tier beneficiaries: “Any beneficiary...that could receive amounts in the trust representing the employee’s interest in the plan that were not distributed to” the first tier beneficiaries.

Step 3: Why we care

From the list of potential beneficiaries, we must determine which beneficiaries are “countable” and which are “disregarded.”

- All first tier beneficiaries are “countable”
- Some second tier beneficiaries are disregardable under Step 4
- The countable beneficiaries determine DB (or NonDB) status and the payout period for the trust.

Step 3: Examples

First vs. Second tier: A basic simple trust.
This is the trust the IRS has in mind!

- Trust says “Pay income to Spouse for life, on her death pay principal to Child, or if he is not living, to Charity X.” Spouse and Child both survive participant.
- POTENTIAL beneficiaries (Step 2) are Spouse, Child, and Charity X.
- Spouse is the only first tier beneficiary. Child and Charity X are second tier.

Step 3, simple example, cont.

How did I figure out the tiers?

- Spouse is the only one entitled (or eligible) to receive \$ upon participant's death. Everyone else (child & charity) must wait until she dies.
- Child is second tier. He can get \$ only after death of another beneficiary (Spouse).
- Why isn't Charity "3rd tier?" Because there is **NO SUCH THING** as 3rd tier. Only 1 + 2!

Step 3, setting up tiers, cont.

Harder example! “Spray” trust...

- Trust says “pay income to such persons as trustee deems advisable from class consisting of my spouse and all my issue living from time to time. On spouse’s death pay principal to my issue then living or if none pay to Charity X.”
- Participant is survived by Spouse, 3 children, and 4 grandchildren.

Step 3, cont.

Harder example: Spray trust, cont.

- First tier: Spouse & *all issue living at P's death*. All are eligible to receive \$ after P's death without waiting for someone else to die.
- Second tier is Charity X.
- What about later-born issue? Trick question: they don't exist so they are not in ANY "tier."
- Hint: The system is prejudiced against spray trusts

Step 3: Really hard example

Non-death contingency

- P's Trust says: "Pay income to Spouse until his death or remarriage. Upon Spouse's death or remarriage, pay principal to Child if living, otherwise to Charity X." Spouse and Child both survive P.
- Tier 1: Spouse---obviously. He gets income starting at P's death....But...

Step 3: Really hard example, cont.

System prejudiced against non-death contingencies

- Child is **ALSO** a first tier beneficiary!
- Child **MAY** not have to wait until death of Spouse...**MIGHT** get \$ upon Spouse's mere remarriage.
- Therefore the only "second tier" beneficiary is Charity.
- Hint: This trust will not qualify as a DB

Step 4: Determine “countable beneficiaries”

Apply the final three “disregard rules”

- **Conduit trust**: Disregard ALL 2d tier benes
- **Age 31 rule**: Disregard 2d tier bene(s) who will inherit only if first tier bene who would inherit outright at or before age 31 dies before inherit-outright age
- **Disregard the 2d choice 2d tier guy**: Any bene who will inherit only if some OTHER 2d tier bene who would inherit outright on death of 1st tier predeceased such 1st tier bene.

Case studies to illustrate Step 4 & its three disregard rules

...and some trust accounting and income tax points along the way

- Conduit trust for spouse: To capture special spousal RMD deal in a trust.
- Age 31-rule trust: To get benefits of a conduit trust without using a conduit trust for minor beneficiaries (whether or not EDBs)
- Any other trust: The 2d choice 2d tier guy rule = the old “mere potential successor” rule

Conduit trust example

Conduit trust gets same deal as conduit beneficiary would get if named directly

- Conduit trust: All distributions from the retirement plan to the trust must IMMEDIATELY be paid out to the beneficiary (the “conduit beneficiary”) as long as he/she lives
- After death of the conduit beneficiary, trust can provide whatever you want--e.g. pay to charity--because all 2d tier benes are disregarded.

Conduit trust, cont.

Proposed Regulations definition

- “...a see-through trust, the terms of which provide that, with respect to the deceased employee's interest in the plan, all distributions will, upon receipt by the trustee, be paid directly to, or for the benefit of, specified beneficiaries.”
- Payment of trust expense appropriately allocated to the benefits is ok too.
- Payments must continue for life of the c.b.

Why use a conduit trust?

For spouse yes; for other benes, maybe occasionally

- Because the conduit bene = sole DB, the trust gets the same deal he/she would have gotten if named directly as DB (except no rollover)
- For a spouse, this is the **ONLY** way to get special spousal deal if naming a trust
- But you do **NOT** need a conduit trust to get the special deal for D/CI bene or for a minor-child EDB or to get 10 yr rule for PODB

Why use a conduit trust, cont.

Occasionally? To allow charity as remainder bene

- E.g. parent wants to leave IRA to adult non-D/CI child, to be paid out over 10 years. If child dies before end of 10th year, remaining trust assets go to charity.
- Conduit trust for child with remainder to charity accomplishes this...but this is not an “everyday” type of estate plan.

Conduit trust for spouse: Example

How to draft it

- Have a provision defining and dealing with retirement accounts subject to s. 401(a)(9)
 - ▶ That would include IRAs, 401(b)'s, 401(k)'s, etc.
 - ▶ Maybe exclude Roth accounts?
- Tell trustee it must withdraw each year any amount required by law to be withdrawn
 - ▶ You don't really have to say this because trustee has to do this anyway! But it's customary and shows trustee you are aware of the RMD rules.

Conduit trust for spouse, cont.

Drafting: Additional amounts to be withdrawn?

- Then add other amounts if any to be withdrawn (in addition to RMD) such as:
- If this is a marital deduction trust, “greater of the RMD or the income of the IRA”
 - ▶ What is the income of the IRA? Trust accounting!
 - ▶ See Rev Rul 2006-26 for IRS definition: Internal income of the account (or a unitrust amount between 3% and 5%)
 - ▶ See state law and your trust instrument

Conduit trust for spouse, cont.

...and MORE amounts to be withdrawn!

- Unless you want spouse to starve, add:
 - ▶ Such additional amounts if any as the trustee deems needed for spouse's health, care, and support in standard of living (etc.)
- For maximum flexibility, add:
 - ▶ Such additional amounts if any as the trustee deems advisable for the purposes of this trust
 - ▶ And be sure to define such purposes someplace...

Conduit trust for spouse: Example

After describing what trustee must/may withdraw from the IRA, the trust MUST include the following:

- Trust MUST say that all IRA distributions received by the trust will be paid forthwith to S (or applied for her benefit)
- Trust can provide whatever P wants for trust terms after S's death...e.g., distribution to charity or perpetual trust for P's issue...because all 2d tier beneficiaries are "disregarded" in applying the RMD rules.

Conduit trust example

Income tax treatment of this trust

- Assume the IRA contains no after-tax money
- Each distribution from the IRA to the trust is includible in the trust's federal gross income and "DNI"
- Each distribution from the trust to the spouse is deductible as DNI and includible in spouse's gross income. Now....

Conduit trust example, cont.

Trust accounting income vs. federal gross income

- You care about **trust accounting income** if:
- Your trust seeks to qualify for the estate tax marital deduction, for which spouse must be “entitled to all income” of the trust for life. IRC 2056(b). That means TA income! Or if:
- Your trust distributes income and principal differently e.g. “Income to spouse, principal to children upon spouse’s death.”

Trust accounting income, cont.

Rev. Rul. 2006-26 defines TAI for IRAs

- IRS will accept either of these definitions of “income” of the IRA for your trust for marital deduction purposes
- The “internal income” of the IRA---e.g., interest and dividends earned inside the IRA
- A “unitrust” payout of 3%-5% if allowed under applicable state law

Trust accounting income, cont.

STRONGLY RECOMMENDED: Include definition of “income” (for trust accounting purposes) in your trust

- Use one of the IRS approved methods
- Otherwise you may be stuck with state law, either inadequate or inappropriate
- Don't think you can coast using “federal gross income” as trust accounting income!
- The beneficiaries may sue you!
- And what will you do with a Roth account?

Conduit trust for spouse, cont.

RMD treatment

- Spouse is the only “1st tier” beneficiary
- 2d tier benes are “disregarded”
- Spouse deemed sole beneficiary of this trust so trust gets the special spousal/EDB deals:
- RMDs start later of year after P’s death or what would have been P’s 1st RMD year
- Spouse’s life expectancy “recalculated annually”

Conduit trust for spouse, cont.

What difference recalculation of LE makes

- Surviving spouse age 66 has 22-year life expectancy
- “Regular” DB trust of which she was oldest countable beneficiary would have 100% payout within 22 years (spouse age 88)
- “Conduit” trust with recalculation does not “run out” of life expectancy until spouse age 120!

Conduit trust for spouse, cont.

Problem pointed out by Sy Goldberg, Esq.:
Can spouse elect 10-year rule?

- Prop. Reg. § 1.401(a)(9)-3(c)(5)(iii) provides that the 10-year rule may apply to an EDB if:
- The participant (P) dies before his RBD and
- The retirement plan requires it, or permits P or the EDB to elect it and P (or EDB) does so elect.
- In case of conduit trust, who can elect?
Trustee, EDB, nobody?

Conduit trust for other DBs/EDBs?

Might be useful in some situations but no big “RMD” benefit

- Conduit trust for PODB would get same 10-year rule as PODB named directly, but would allow client to control RATE of payout over 10 years and to name a charity as remainder bene (if PODB dies within 10 years)
- An accumulation trust for PODB would get the same 10 year payout but would not require payouts to PODB & could not have charity as remainder bene

Next disregard rule: Age 31 rule

Disregard 2d tier benes who take only if 1st tier bene dies before end of his/her age 31 birthday year

- First tier beneficiary is an **individual who is age 31 or younger**
- Could be an EDB (minor child of the IRA owner) or not...*e.g.*, IRA owner's child who is age 22, or grandchild, or unrelated young individual
- If that individual will inherit the trust **OUTRIGHT** at age 31 or younger, disregard all 2d tier benes

Age 31 rule, cont.

Example 1

- Parent leaves IRA to trust for his minor child, to be distributed outright at age 31 (or younger).
- If child dies before that age, \$ goes to charity
- Minor child is an EDB...but you don't need a conduit trust to get the (quasi) LE payout because child is deemed sole bene of trust---charity is disregarded.

Age 31 rule, cont.

Example 2

- *Grandparent* leaves IRA to trust for minor *grandchild*.
- Trustee to use income and principal for health, education, support etc. and distribute all outright at age 31.
- Trust gets 10-year rule (because GC is a PODB). Remainder bene is disregarded even if it is an older person or a charity.

Age 31 rule, cont.

Grandpa example, cont.

- Same facts as preceding example, but distribution outright to GC is to be at age 35 instead of age 31. What difference?
- Difference is in the payout rules for trust: Now the 2d tier bene counts.
- If it's a charity (nonindividual) trust is not a DB! NonDB rules apply.
- If it's an older person, his/her LE is payout period during 10 years if GP dies after RBD!

Best thing about the age 31 rule

It enables you to have a life expectancy payout trust for minor-child EDBs WITHOUT having a conduit trust

- The trust can be a regular “accumulation” trust (“use income and principal as trustee deems best for child’s health, support,” etc) and still get “EDB” (life expectancy) payout
- ...as long as the trust becomes a “conduit trust” by age 31! (Because remaining IRA must be distributed out to the formerly-minor-child EDB no later than that age.)

Age 31 rule: Warnings

Rule applies only to amounts distributable to *1st tier benes!*

- E.g., “income to spouse for life, remainder to child to be held in trust until he reaches age 31, if child dies before that age, then to charity X.” Spouse & child (age 15) survive P.
- Spouse is 1st tier, child & charity = 2d tier.
- Charity is not “disregardable!”

Age 31 rule: Problems with trusts for minor child EDBs

Assume a spray trust for P's 4 children, all under 21

- Good news! All beneficiaries are EDBs so LE payout applies
- Bad news! Distribution period based on oldest child's life expectancy. Usually this is a "minor" concern...but
- Worst news! 10 year payout countdown for all the children starts upon pre age 21 death of any one of the children

Disregard rule #3: Disregard the 2d-choice 2d-tier guy

Successor to the old “mere potential successor” rule

- Find a 2d tier beneficiary who will inherit **OUTRIGHT** on death of 1st tier benef. This is the “first choice” 2d tier guy.
- Now find *another* 2d tier bene, this time someone who will inherit only if the above first-choice guy does not survive the 1st tier bene...and disregard him,her, or it!
- Easy peasy!

Disregard rule #3: Example

Simple example: This is what the IRS is thinking of

- Trust: “Income to my spouse for life, upon his death pay principal to my then living issue, or if no such issue then living, to Charity X.”
- P dies, survived by spouse & 3 children.
- Listable: Spouse, 3 children, + Charity X.
- 1st tier: Spouse. 2d tier: Children & charity.
- First choice 2d tier guys = children. Charity disregardable as 2d choice 2d tier guy.

Disregard rule #3: Example, cont.

But what if some beneficiaries predecease P? Your trust must be valid for all such contingencies, right?

- Trust: “Income to my spouse for life, upon his death pay principal to my then living issue at age 45, or if no such issue then living, to Charity X.”
- What if no issue survive P? Now charity is sole beneficiary after S. Should disposition plan be different if no issue survive?
- If spouse doesn't survive P, & issue don't inherit by age 31, charity not disregarable.

Disregard rule #3, cont.

Another example: the spray trust (remember?)

- “Income & principal to my spouse & children for health & support. On death of spouse outright to children or if not living to charity.” Spouse & 3 children survive P.
- Listable: Spouse, 3 children, charity.
- 1st tier: Spouse AND children! Charity is not disregardable because it is in effect the “1st choice 2d tier guy!”

How to keep DB status for perpetual trust?

“Last man standing” approach

- E.g. trust provides pay income & principal in trustee’s discretion to “my spouse and my issue in perpetuity...but if no one is living in that group terminate & pay to charity”
- Change to: “If at any time *there is only one person in that group living*, terminate trust and distribute it to that one person.”
- See next slide for possible effect....

Last man standing example, cont.

Count all class members living when trust is written...

- E.g., if P dies right now, the class would be his spouse, 3 living children, & 4 living GC
- Point out to client: If 7 of those 8 people die before any more issue have been born to the existing issue, the trust will be distributed outright to the last surviving member of the above group (even though he/she might later have more issue)

Last man standing, cont.

Comment...

- Perpetual trust may not be best destination for retirement benefits (if you care about “DB” treatment)
- Code provides 10 year or life expectancy payouts for INDIVIDUAL beneficiaries....a perpetual trust resembles a corporation more than an individual

Drafting to navigate these rules

Consider these points to avoid negative impact

- If using a “spray” trust, aim for a young individual wipeout beneficiary rather than a charity or other nonindividual
- If using a nondeath contingency (such as “remarriage”) consider carefully the countable beneficiaries
- Keep in mind how much if at all you “care” about DB status and applicable distribution period

RMDs: The 6 Types of Trusts

Whatever trust you draft will be one of the following 6 types and have RMDs accordingly...

- Non-DB trust: 5-year rule or ghost LE
- Type II AMBT: LE of oldest D/CI bene
- Conduit trust for DB or EDB: same deal as DB or EDB him/herself would get
- DB trust with at least one minor child EDB
- DB trust all countable benes are EDBs
- DB trust which is none of the above: 10-year rule

NonDB Trust: 5-yr rule or ghost LE

Simple...and sometimes longer than DB/EDB treatment!

- Death before RBD
 - ▶ 100% distribution in year of 5th anniversary of death (6th if one of the years was 2020)
 - ▶ No RMDs before that final year
- Death after RBD: Bene takes year of death (YOD) RMD if not taken by deceased participant, then:
 - ▶ Annual distributions over decedent's life expectancy ("ghost life expectancy")

Why 5 years is nothing to sneeze at...

Suppose trust for 4 adult non-D/CI children....

- An IRA distribution to the trust can be spread among 5 taxpayers---the 4 children and the trust
- Payout under the “5-year rule” could mean 6 taxable years (e.g. participant died 2/1/2023, final distribution must be by 12/31/2028 = 6 taxable years)
- 5 taxpayers times 6 taxable years = 30 chances to run up the brackets.
- Compare that to a lump sum distribution
- ...But it’s still not like a 50-year payout under pre-SECURE law. Consider predeath Roth conversions!

Type II AMBT

No distributions to anyone other than D/CI bene during his/her life; **may have charity as remainder bene (but not a DAF or supporting organization)**

- ▶ **Death before RBD**
- ▶ Annual distributions over LE of oldest D/CI beneficiary
- ▶ May be able to elect 10-year rule instead
- **Death after RBD**
- ▶ Annual distributions over LE of oldest D/CI beneficiary
- ▶ ...Or ghost LE if longer

Conduit trust for DB or EDB

Same deal as the DB or EDB him/herself would get

- **Surviving spouse sole DB: LE recalculated annually; RMDs to trust start when decedent would have reached applicable RMD age**
- **Conduit trust for PODB gets 10-year rule.**
- **Conduit trust for minor child-EDB gets LE payout to age 31.**

DB trust with at least one minor child-EDB

Looks good but be careful!

- Death before RBD
 - ▶ Annual distributions over LE of **oldest countable beneficiary**...NOT necessarily the oldest minor EDB!
 - ▶ 100% distribution 10 years after **oldest minor child EDB** reaches age 21 or earlier dies
- Death after RBD
 - ▶ Same as above (or ghost LE if longer)

DB trust all countable beneficiaries of which are EDBs

E.g., “income to spouse for life, remainder to D/CI child”

- **Death before RBD**
 - ▶ Annual RMDs over LE of oldest countable beneficiary; 10 year rule may be elected
 - ▶ Final RMD: 100% distribution in year of 10th anniversary of death of oldest countable beneficiary
- **Death after RBD**
 - ▶ Annual: Same as above (or ghost LE if longer)
 - ▶ Final RMD: Same as above

DB trust which is none of the above: 10-year rule

Trust qualifies as a “designated beneficiary trust” but is not one of the above.

■ Death before RBD

- ▶ No RMD for year of participant’s death, or for following years 1-9
- ▶ 100% of account is the RMD in year 10

■ Death after RBD

- ▶ Must take year of death RMD if not taken by P
- ▶ Annual distributions for next 9 years over LE of oldest countable trust bene (or ghost LE if longer)
- ▶ 100% of account is the RMD in year 10

Part 2: Post-death changes

Proposed regulations' generous treatment of post-death changes to a trust named as bene of retirement account

- Mere possibility as of date of P's death that, someday, the trust may someday be altered by reformation or decanting does not adversely affect "identifiability" of trust beneficiaries as of date of death
- Reformations/decanting are ignored until they actually occur.

Part 2: Post-death changes, cont.

Changes to trust made via reformation or decanting

- 9/30 of year after year of participant's death is the "beneficiary finalization date" (BFD)
- Trust changes via reformation or decanting (if valid under state law) effected prior to BFD are effective retroactive to date of death.
- Such changes if made later cause the trust to be re-tested at time of such change.

Part 2: Post-death changes, cont.

Effect of “retesting” for changes made after BFD

- If the change “downgrades” the RMD status of the trust (e.g. adds a NonDB or replaces an EDB with a PODB), the change is effective prospectively only...it does not retroactively disqualify for prior years
- If the change purports to “improve” the RMD status of the trust (e.g., eliminates a NonDB) the change is given no effect for RMD purposes

Part 2: Post-death changes, cont.

Other post-death changes: Disclaimer, distribution, before RMD to “remove” a beneficiary

- If X is a “countable beneficiary” as of the DOD, but due to distribution has no further interest in benefits as of BFD, disregard X. E.g., charitable bequest in the trust is distributed in full prior to BFD.
- A countable beneficiary as of DOD who disclaims interest via QUALIFIED disclaimer prior to BFD not countable.

Part 2: Post-death changes, cont.

Death of beneficiary between DOD and BFD

- Death of a countable beneficiary between DOD and BFD does NOT remove him/her as a countable beneficiary...
- Apparently this is because his/her estate succeeds to the interest. If the interest was extinguished by such death, the beneficiary should not count, but this may not be clear.

Part 2: Post-death changes, cont.

Planning implications

- Study RMD status of trust IMMEDIATELY upon participant's death and consider whether any post-death changes could improve it (e.g., paying off a NonDB prior to the BFD or a reformation of the trust)
- Make such changes prior to the BFD
- If possible build in options for trustee to make post-death changes

Part 3: Multiple trusts; subtrusts

Multiple trusts: Trust #1 is named beneficiary; at some point all or part of trust #1 is going to be paid to trust #2

- If all or part of the trust named as beneficiary “pours into” another trust, just treat the two as one combined trust instrument for RMD testing purposes
- Test all aspects and all beneficiaries of both trusts as one trust...for determining first and second tier benes, applying “disregard rules,” etc.

Part 3: cont.: Subtrusts

Arbitrary and capricious distinction applied to “subtrusts”

- Background: Mom dies leaving IRA to her 3 adult non-D/CI children equally.
- Children divide the inherited IRA into 3 equal inherited IRAs, one per child.
- If the above is accomplished by **12/31 of year after year of Mom's death**, each child is treated for all RMD purposes as if he/she inherited a separate IRA.

Part 3: cont.: Subtrusts

Requirements for “separate accounts” treatment

- This is called “separate accounts.” Each child treated for RMD purposes as if he/she inherited a separate IRA (“separate account”)
- Requirements:
 - ▶ Division completed by 12/31 of year after death
 - ▶ There must be proper accounting for income, appreciation, etc between DOD and date of division. E.g. can’t assign gains to one child, losses to another, before dividing.

Part 3: cont.: Subtrusts

What if, instead, Mom left her IRA to a trust...that upon her death would immediately terminate and be distributed equally outright to her 3 children?

- Drumroll: Enter the proposed regulations!
- Continuing IRS policy started in 2002, separate accounts treatment is NOT allowed for multiple interests created under a single trust named as beneficiary! (unless...)
- Forced by SECURE, IRS changed that policy to add the following exception...

Part 3: cont.: Subtrusts

SECURE overruled IRS for any trust that has a D/CI bene

- Same example: Mom's IRA left to trust that immediately is divided at her death into 3 subtrusts for 3 kids, one of whom is D/CI
- If separate accounts are set up by 12/31 of year after Mom's death for these 3 subtrusts, **ALL THREE** will be entitled to "separate accounts" treatment---even the subtrusts for non-D/CI children!

Part 3: cont.: Subtrusts

Action recommendation

- If client is leaving benefits to a trust that divides, after client's death, into multiple shares distributed outright to various beneficiaries, or multiple "subtrusts," leave the benefits directly to such multiple beneficiaries or subtrusts by naming them on the beneficiary designation form
- Do not name the "funding trust" as beneficiary...unless this would produce a better result!

Part 3: cont.: Subtrusts

Why separate accounts treatment matters to the beneficiaries even if you think it doesn't

- Example: Mom died leaving IRA to 3 adult non-D/CI children. What difference does it make whether they are named directly as benes or take through a trust? 10-year rule applies to all of the either way, right?
- If Mom died after her RBD, then each child must take RMDs in years 1-9 based on his/her LE (if separate accounts) or OLDEST child's LE (if not "separate accounts")

Part 3: cont.: Subtrusts

But what if combined treatment would be BETTER?

- Ralph is 50 and has a new baby, age 1. Leaving his IRA to a trust that divides into 3 subtrusts, 50% to baby and 25% to each of his older children (ages 22 and 25).
- Because baby is a minor child-EDB, if the trust is treated as one COMBINED trust, it will get a life expectancy payout (based on the 25-year old's life expectancy), with 100% payout in 30 years when baby reaches 31!

The End

Have fun making sense of all this

- Consider Roth conversions during life to ease post-death RMD pain to trust
- Draft to achieve client's goals, not to squeeze into weird RMD rules
- 5 or 10 years is often the best “deal” available for post-death distributions, so plan who will pay the income taxes, when, and with what!