Opportunities and Traps Regarding Drafting Trusts and Beneficiary Designations for IRAs and Qualified Retirement Plans under Final Regulations Governing Required Minimum Distributions

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September 30, 2005

On January 17, 2001, the Internal Revenue Service simplified and improved its proposed regulations governing required minimum distributions (RMDs) from IRAs and other retirement plans. On April 17, 2002, the IRS finalized these regulations (the "Final Regs").[1] The *Journal of the Missouri Bar* published the author's analysis of those proposed regulations and the Final Regs.[2] After summarizing the changes from the proposed regulations to the final regulations, this article presents solutions for meeting clients' needs in various situations.

For those who have not read the prior article, this paragraph provides a brief introduction to the topic. This article discusses how the Final Regs apply to defined contribution (including 401(k) and other profit-sharing plans and money purchase pension plans (including target benefit plans)) qualified retirement plans[3] and to IRAs[4] (either referred to as a "plan" in this article). The Final Regs liberalize payment options both during the lifetime of plan participants and after their deaths. Taking advantage of the flexibility for post-mortem deferral takes particular care. For beneficiaries to receive plan benefits through a trust rather than outright, the rules' traps must

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[1] T.D. 8987.

[2] "Analysis of January 17, 2001 Proposed Regulations Governing Required Minimum Distributions From IRAs and Qualified Retirement Plans," Volume 57, No. 3, May-June 2001; "New Rules Provide Opportunities and Traps Regarding Beneficiary Designations for IRAs and Retirement Plans, Volume 58, No. 4, July-August 2002.

[3] Section 401(a)(9) of the Internal Revenue Code of 1986, as amended (the "Code").

[4] Code § 408(a)(6) and 408(b)(3) apply rules similar to Code § 401(a)(9) to individual retirement accounts and individual retirement annuities. Reg. § 1.408-8(A-1).

be avoided in the drafting of the trust instrument. Furthermore, some of flexibility available to IRAs may not be available to participants in qualified retirement plans.

COMPARISON OF FINAL REGULATIONS TO PROPOSED REGULATIONS

The Final Regs apply to determine RMDs for calendar years beginning on or after January 1, 2003.[5] For determining RMDs for 2002, taxpayers may rely on the Final Regs, the 2001 proposed regulations, or the 1987 proposed regulations.[6] **A reader who is not familiar with these rules may want to wait to read the rest of this comparison section until after reading the rest of this article.**

The Final Regs use a longer life expectancy than the 2001 proposed regulations, so that distributions may be stretched over a longer period of time. The preamble to the Final Regs explains that this change was required by section 634 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

The deadline for determining the designated beneficiary has been moved up from December 31 to September 30 of the calendar year following the calendar year of the owner's death.[7] (Any references in this article to "owner" mean the owner of an IRA or a participant in a

[5] Reg. § 1.401(a)(9)-1(A-2)(a). Section 3.01 of Rev. Proc. 2002-29 provides:

> In general, qualified plans must be amended by the last day of the first plan year beginning on or after January 1, 2003 to the extent necessary to comply with the requirements of the §401(a)(9) Final and Temporary Regulations. Whether and the extent to which a particular plan must be amended depends on the plan's current terms. Any plan amendments for the §401(a)(9) Final and Temporary Regulations must apply in determining required minimum distributions under the plan for calendar years beginning on or after January 1, 2003. If a plan sponsor begins operating its plan under the §401(a)(9) Final and Temporary Regulations on a date in 2002, then the amendments must also apply in determining required minimum distributions under the plan for 2002 that are made on or after such date, although the amendments are not required to be adopted before the last day of the first plan year beginning on or after January 1, 2003.

[6] Portion of the preamble to the Final Regs entitled, "Effective Date." Note that Announcement 2002-49 provides:

> In Rev. Proc. 2002-10, 2002-4 I.R.B. 401, the Service provided that existing model IRAs, SEPs and SIMPLE IRA plans may not be used after June 1, 2002, to establish new IRAs, SEPs or SIMPLE IRA plans. In response to comments, the Service is extending the June 1 deadline to October 1, 2002. Thus, a financial institution may use an existing model IRA to establish a new IRA for a customer through October 1, 2002. Similarly, an employer may use an existing model SEP or SIMPLE IRA plan to establish such a plan through October 1, 2002. The deadlines by which revised model forms must be adopted under Rev. Proc. 2002-10 are unchanged.

[7] Reg. § 1.401(a)(9)-4(A-4)(a).

qualified retirement plan.) If the owner died before 2003, the designated beneficiary must be redetermined under the Final Regs and the applicable distribution period must be reconstructed to determine RMDs upon the effective date.[8] This calls into question the effectiveness of any actions taken between October 1, 2001 and December 31, 2001 in determining the designated beneficiary for any individual who dies in 2000. The policy behind applying this earlier date to prior years is questionable. Because the goal of moving the beneficiary designation deadline from December 31 to September 30 was to provide administrative convenience in the year following the year of death, there would appear to be no policy reason to apply the September 30 deadline to determining the designated beneficiary for owners who died before 2001, since the deadline for their first RMDs has already passed. The author's understanding is that the IRS did not intend to call into question the effectiveness of any actions taken between October 1, 2001 and December 31, 2001 in determining the designated beneficiary for any individual who dies in 2000, and that the IRS would be receptive to a letter ruling request.

The preamble to the Final Regs provides that a disclaimer must be a qualified disclaimer to be recognized in determining designated beneficiaries. However, even though the IRS recognizes qualified disclaimers, not all plans recognize them. Plans are not required to recognize state laws that ordinarily govern property rights. In *Egelhoff v. Egelhoff*,[9] the U.S. Supreme Court stated:

> A Washington statute provides that the designation of a spouse as the beneficiary of a nonprobate asset is revoked automatically upon divorce. We are asked to decide whether the Employee Retirement Income Security Act of 1974 (ERISA), 88 Stat. 832, 29 U.S.C. § 1001 *et seq.*, pre-empts that statute to the extent it applies to ERISA plans. We hold that it does.

This reinforces the position the IRS took in the 2001 proposed regulations and in the Final Regs, that the state law effects on a beneficiary designation will be ignored except to the extent recognized by the retirement plan. One hopes that when a revocable trust is named as the beneficiary of a retirement plan, any state law effects on that trust would be respected. However, this decision clearly states that ERISA's policy is to relieve plan administrators from the burden of researching the law in the various states, so it would be prudent to have disclaimers, etc. expressly provided for in the trust or in the beneficiary designation.

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[8] Reg. § 1.401(a)(9)-1(A-2)(b).

[9] 532 U.S. 141, 121 S.Ct. 1322, 1326 (2001). However, in determining how retirement plans actually pass, check to see whether the federal courts of the applicable jurisdiction recognize a federal common law doctrine. See *Hill v. AT&T Corp.*, 125 F.3d 646 (8th Cir. 1997); *Mohamed v. Kerr*, 53 F.3d 911 (8th Cir. 1995), cert. denied, 516 U.S. 868 (1995). The author thanks Charles A. ("Clary") Redd for these citations; Clary is not responsible for any future developments the author might miss. See *Keen v. Weaver*, 121 SW3d 721 (Texas 2003), cert. denied, 540 US 1047 (2003).

The IRS has always taken the position that an estate cannot qualify as a designated beneficiary. According to the preamble to the Final Regs, if an estate transfers its ownership in a plan to one or more individuals before the beneficiary designation date, generally the individual(s) would not be treated as the designated beneficiary; instead, the estate is considered the beneficiary, and because an estate is not a qualified beneficiary, the plan would be treated for the purposes as having no beneficiary.[10] However, it may be possible for a plan sponsor to help owners avoid this harsh result.[11] The preamble to the Final Regs clarifies that a decedent's revocable trust that elects to be taxed as an estate is not considered to be an estate under the RMD rules.[12]

The Final Regs also adopt a stricter approach regarding determining which trust beneficiaries are the designated beneficiaries. The 2001 proposed regulations allowed beneficiaries to be eliminated by distribution, disclaimer or otherwise. The Final Regs removed "or otherwise" from the preamble and tightened the examples of when a beneficiary can be eliminated, apparently removing much flexibility.[13] This new approach casts doubt on whether the IRS would respect a trust reformation completed by the beneficiary designation date. Curiously, on February 4, 2002, shortly before promulgating the Final Regs, the IRS issued Letter Ruling 200218039, which respected a court modification of a trust under the 1987 proposed regulations. Did the IRS have a change of heart regarding court modifications, or did the Final Regs unintentionally use language that may seem adverse to court modifications? Probably the latter, based on Letter Ruling 200607031 and 200620026.

Any post-mortem division of a trust might not be recognized by the IRS, which could make disastrous naming a revocable trust as a beneficiary if the revocable trust as a whole has disqualified beneficiaries (such as charities, or perhaps an older beneficiary) to whom such benefits are not finally allocated but to whom such benefits might have been allocated. Again, in contrast to the Final Regs, Letter Ruling 200218039 also held that, because the trust expressly provided that it was broken into two separate shares, each separate share was a separate designated beneficiary. Under the Final Regs, that trust would not be considered as separate shares, since the trust was named directly as the beneficiary.[14] Letter Ruling 200218039 specifically stated it did not consider the impact of the 2001 proposed regulations. Letter Ruling 200432027, however, allowed the decedent's IRA that was payable to a revocable trust to be split into separate accounts for his children after paying estate taxes; however, the oldest child's life expectancy was required to be used for each account.

One of the wrinkles for IRAs the 2001 proposed regulations introduced, which the Final Regs retained, is a new requirement that the trustee, custodian or issuer (collectively referred to

[10] If a charity is a beneficiary, the estate could simply assign the retirement plan to the charity, assuming the plan administrator does not object. See Letter Ruling 200617020.
[11] See the text accompanying footnote 65.
[12] See footnote 62.
[13] See the paragraph of text accompanying footnotes 90-94.
[14] See the text accompanying footnote 80.

as "trustee" in this paragraph) of an IRA must report the RMD to the owner and the IRS.[15] For 2003, reporting to the owner is all that is required. By January 31 of each year, each IRA trustee must furnish the owner a notice informing the owner: (a) the deadline for taking RMDs, (b) that the trustee will be informing the IRS that an RMD is due with respect to any post-2003 RMDs, and (c) either the calculated amount of the RMD or an offer to calculate the amount of the RMD.[16] IRA trustees must indicate on Form 5498 that an RMD is due (but need not indicate the amount), starting with 2003 Forms 5498 and 2004 RMDs.[17] This rule does not prevent owners of multiple IRAs from taking RMDs out of any combination of IRAs.[18]

RMDS WHILE OWNER IS LIVING

Distributions while the owner[19] is living must start no later than the required beginning date ("RBD"). Generally, the RBD is April 1 of the calendar year following the calendar year in which the owner attains age 70½.[20] For example, the RBD of a person born June 30, 1933 would be April 1, 2004, and the RBD of a person born July 1, 1933 would be April 1, 2005.[21] However, in the case of a qualified retirement plan (but not an IRA), if the employee is not a 5% owner of the employer, then the RBD is April 1 of the calendar year following the calendar year in which the owner retires.[22]

Calculating RMDs is a two step-process, dividing the value of the owner's plan assets by the appropriate life expectancy factor. The plan assets are measured on the last valuation date of the calendar year before the distribution calendar year, with certain adjustments.[23] Such

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[15] Reg. § 1.408-8(A-10).
[16] IRS Notice 2002-27, section entitled "Reporting," Part I.
[17] *Id.*, Part II.
[18] Reg. § 1.408-8(A-9).
[19] Any references in this article to "owner" mean the owner of an IRA or a participant in a qualified retirement plan.
[20] Code § 401(a)(9)(C)(i)(I); Reg. § 1.408-8(A-3).
[21] Reg. § 1.401(a)(9)-2(A-3).
[22] Code § 401(a)(9)(C)(i)(II), as limited by Code § 401(a)(9)(C)(ii).
[23] Reg. § 1.401(a)(9)-5(A-3). The preamble to the Final Regs states:

> **Calculation Simplification**
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> In response to comments that there are too many variables that might change during a distribution calendar year for an accurate calculation of the required minimum distribution for the year by the trustee at the beginning of the year, a number of simplifying changes are included in these final regulations. For lifetime distributions, the marital status of the employee is determined on January 1 each year. Divorce or death after that date is disregarded until the next year. Further, a change in beneficiary due to the spouse's death is not recognized until the following year. Contributions and distributions made after December 31 of a calendar year are disregarded for purposes of determining the minimum

adjustments do not include unpaid RMDs from prior years, a situation most likely to occur when a distribution is deferred from the year in which the owner attains age 70½ and elects to wait until April 1 of the following year. The owner uses one of two tables to determine the appropriate life expectancy factor. In both tables, the owner's life expectancy is recalculated.[24] However, unlike the 1987 proposed regulations, recalculation does not affect distributions after the owner dies (discussed below).[25] The general life expectancy factor is set forth in Appendix A,[26] using the owner's age on his/her birthday during the year with respect to which the distribution is to be made.[27] This table annually recalculates the joint life expectancy of the owner and a hypothetical beneficiary who is ten years younger than the owner. This is as generous as possible, since the Code's incidental death benefit requirements generally preclude the use of the life expectancy of a non-spouse beneficiary who is more than ten years younger than the owner.[28]

This general life expectancy factor applies without regard to any beneficiary designation. Among those who especially benefit from these rules are owners whose spouses are close in age to the owners and owners who prefer to name charities as their beneficiaries.

A different rule applies if the owner's spouse is the sole designated beneficiary of the owner's entire interest at all times during the distribution calendar year. If a spouse is divorced or dies on or after January 2 of the distribution calendar year, the change in marital status does not apply until the next distribution calendar year.[29] If the owner's spouse is the sole designated beneficiary, RMDs are taken over the longer of the period provided under the general rule or the annually recalculated joint life expectancy of the owner and the owner's spouse using their respective attained ages as of their birthdays in the distribution calendar year.[30] Since the general

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> distribution for the following year. An employee's account balance for the valuation calendar year that is also the employee's first distribution calendar year is no longer reduced for a distribution on April 1 to satisfy the minimum distribution requirement for the first distribution calendar year. Contributions made after the calendar year that are allocated as of a date in the prior calendar year are no longer required to be added back. The only exceptions are rollover amounts, and recharacterized conversion contributions, that are not in any account on December 31 of a year. These changes are made to the qualified plan rules as well as IRA rules to maintain the parity between the rules.

[24] Reg. § 1.401(a)(9)-5(A-4).
[25] Reg. § 1.401(a)(9)-5(A-5).
[26] Reg. § 1.401(a)(9)-9(A-2).
[27] Reg. § 1.401(a)(9)-5(A-4)(a).
[28] Code § 401(a)(9)(G). See also the "Uniform Lifetime Table" section of the Preamble to the Final Regs.
[29] Reg. § 1.401(a)(9)-5(A-4)(b)(2).
[30] Reg. § 1.401(a)(9)-5(A-4)(b)(1).

rule assumes the beneficiary is ten years younger than the owner, this rule can be applied as follows:

- If the spouse's birthday occurred in a year that is more than ten calendar years before the calendar year in which the owner was born, use the spouse's life expectancy.
- Otherwise, apply the general rule.

If the spouse's life expectancy is used, then the expected return multiples under a new joint recalculation table apply.[31]

This rule also applies if a trust is the beneficiary of the plan and the spouse is considered the sole designated beneficiary. Whether the spouse is considered the sole designated beneficiary depends on whether the trust is what some commentators referred to as a "conduit trust" when describing the 1987 proposed regulations. The regulations provide a specific example of a conduit trust. If, "upon receipt," the trustee distributes "directly" to the surviving spouse all amounts distributed from a plan to the trust, then the spouse is considered the sole designated beneficiary.[32] However, if it is possible that amounts distributed from a plan to the trust will be held for the remainder beneficiaries rather than for the surviving spouse, the spouse would not be the sole designated beneficiary, even though the surviving spouse's life expectancy may be the measuring life for calculating RMDs.[33] Some commentators suggest that a conduit trust would require that all RMDs be distributed to the surviving spouse. Their suggestion does not go far enough. What if the trustee withdraws from the plan more than the RMD? A conduit trust should provide that, upon receipt, all withdrawals from a plan be distributed directly to the surviving spouse.

Satisfying the RMD depends on the value of what is distributed, rather than how much is included in income.[34] Nontaxable amounts, such as recovery of basis or net unrealized appreciation on employer securities, count toward satisfying the RMDs. For example, when a plan distributes employer stock in a lump-sum distribution, the stock distribution is taxed only to the extent of the plan's purchase price of the stock.[35] The participant could keep the employer securities, taxed at the low original cost, roll over the rest of the lump sum distribution, and count the value (rather than the taxable amount) of the employer securities towards the employee's RMDs.

Finally, in 2006 and 2007, RMDs can be satisfied by transferring up to $100,000 to charity.

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[31] Reg. § 1.401(a)(9)-5(A-6) calls for using the expected return multiples in Reg. § 1.401(a)(9)-9(A-3).
[32] Reg. § 1.401(a)(9)-5(A-7)(c)(3), Example 2.
[33] Reg. § 1.401(a)(9)-5(A-7)(c)(3), Example 1(iii).
[34] Reg. § 1.401(a)(9)-5(A-9)(a).
[35] Code § 402(e)(4)(B).

RMDs After Owner's Death

After the owner's death, various rules apply, depending upon whether the owner died before or after the required beginning date, whether the owner has a designated beneficiary, and whether the owner has more than one designated beneficiary. Furthermore, owners, beneficiaries, and IRA sponsors may want to adopt rules that allow the slowest payout, whereas employers, not wanting the responsibility of administering a plan after an employee's death, typically require immediate distribution to the extent that they can. In the latter case, to maximize flexibility, the owner should consider rolling over from a qualified retirement plan to an IRA while the owner is still living. Caution should be exercised as there may be significant disadvantages to rolling over, including possibly decreased protection from creditors,[36] loss of lower lump sum distribution rates (for people who had attained age 50 when the Tax Reform Act of 1986 was enacted), and loss of a "TEFRA" election, all of which are beyond the scope of this article.

The minimum distribution rules apply to the Roth IRA as though the Roth IRA owner died before the owner's required beginning date.[37] In satisfying the RMD rules, Roth IRAs can be aggregated with other Roth IRAs but not with traditional IRAs.[38]

Although this article focuses on measuring the life expectancy, the reader may be interested in a couple of planning points on making distributions. After using the rules below to calculate the RMDs, the RMDs may be satisfied as described in the section of this article dealing with RMDs while the owner is living.[39] Also, if a plan includes life insurance and the spouse can roll over the proceeds, the spouse may be able to roll over the proceeds into a Roth IRA as follows:[40] A rollover that is effected as a direct plan-to-IRA transfer can include a nontaxable portion.[41] The surviving spouse rolls over the taxable portion into a qualified retirement plan (but not another IRA),[42] leaving only the nontaxable portion in the IRA. The surviving spouse then does a Roth conversion (assuming her adjusted gross income is within the Roth

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[36] To compare qualified plan accounts and IRAs regarding protection from creditors, see the article "Protecting Retirement Plans," by Gideon Rothschild, et al., from the *Journal of Asset Protection* (March 1997), at www.mosessinger.com (Articles/by Topic/Trust and Estates and Wealth Preservation). That article's state-by-state comparison had been updated June 2002 when the author last looked.

[37] Reg. § 1.408A-6(A-14), incorporated by reference into Reg. § 1.408-8(A-1)(c) of the Final Regs.

[38] See Reg. § 1.408A-6(A-15), incorporated by reference into Reg. § 1.408-8(A-1)(c) of the Final Regs; see also Reg. § 1.408-8(A-9) of the Final Regs. A beneficiary of an inherited Roth IRA can aggregate with another inherited Roth IRA only if both were inherited from the same decedent, Reg. § 1.408A-6(A-15).

[39] See text accompanying footnotes 34-35.

[40] This idea is not original to the author, and the author would be happy to refer a reader to the originator of this idea.

[41] Code § 402(c)(2)(A).

[42] Code § 408(d)(3)(A)(ii).

limitations[43]), which is not taxable because none of the account would have been taxable had the surviving spouse withdrawn it.[44] The reinvested life insurance proceeds earn income and are distributed free from tax.

General Rules

The following rules apply if the owner dies before the required beginning date.[45] If the owner does not have a designated beneficiary, the entire plan must be distributed by the end of the calendar year that contains the fifth anniversary of the date of the owner's death.[46]

If an owner who dies before the required beginning date has a designated beneficiary, then distributions must begin as follows:

- If the sole designated beneficiary is the owner's surviving spouse,[47] then distributions must begin no later than the later of (a) the end of the calendar year immediately following the calendar year in which the owner died, or (b) the end of the calendar year in which the owner would have attained age 70½.[48]

- Otherwise, distributions must begin no later than the end of the calendar year immediately following the calendar year in which the owner died.[49] However, the Final Regs have provided a fix for certain late distributions,[50] and a private letter

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[43] Code § 408A(c)(3)(B).
[44] Code § 408A(d)(3).
[45] See text accompanying footnotes 19-21.
[46] Reg. § 1.401(a)(9)-3(A-2), promulgated under Code § 401(a)(9)(B)(ii).
[47] For a description of whether the spouse is considered the sole designated beneficiary, see notes 29 and 30 and accompanying text.
[48] Reg. § 1.401(a)(9)-3(A-3)(b), promulgated under Code § 401(a)(9)(B)(iii), (iv).
[49] Reg. § 1.401(a)(9)-3(A-3)(a), under the authority of Code § 401(a)(9)(B)(iii)(III), which requires distributions payable over the life of a beneficiary to start no later than one year after the date of the owner's death or such later date as the IRS determines. If one experiences ministerial delays in making required distributions, see *Childs v. Commissioner*, T.C. Memo. 1996-267.
[50] Reg. § 1.401(a)(9)-1(A-2)(b)(2) provides:

> A designated beneficiary that is receiving payments under the 5-year rule of section 401(a)(9)(B)(ii), either by affirmative election or default provisions, may, if the plan so provides, switch to using the life expectancy rule of section 401(a)(9)(B)(iii) provided any amounts that would have been required to be distributed under the life expectancy rule of section 401(a)(9)(B)(iii) for all distribution calendar years before 2004 are distributed by the earlier of December 31, 2003 or the end of the 5-year period determined under A-2 of §1.401(a)(9)-3.

The Final Regs do not clarify whether this expressly overrides the requirement that distributions must begin by December 31 of the year following the year of death under Reg. § 1.401(a)(9)-3(A-3)(a) or whether it simply provides relied for missed distributions in the second, third and fourth years following the year of death. Considering that many beneficiaries relying on the 5-

ruling suggests that failure to take timely distributions will not prevent the beneficiary's life expectancy from being used, so long as the penalty for late distribution is paid and the beneficiary does not affirmatively elect to use the 5-year rule.[51]

If the owner dies after the required beginning date, then the following rules apply to distribution calendar years after the distribution calendar year containing the owner's date of death:[52]

- If the owner does not have a designated beneficiary, then over the owner's life expectancy using the owner's age as of the owner's birthday in the calendar year of the owner's death.[53]

- If the owner has a designated beneficiary, then over the longer of (i) designated beneficiary's remaining life expectancy or (ii) the owner's life expectancy using the owner's age as of the owner's birthday in the calendar year of the owner's death.[54] Being able to use the owner's life expectancy is a feature in the Final Regs that was not in the 2001 proposed regulations.

In applying these rules related to distribution after an owner's death, life expectancies are calculated as follows:

- If the owner's life expectancy is used, it is not recalculated; instead, the owner's life expectancy is reduced by one for each calendar year that has elapsed since the date of the owner's death.[55]

- If the owner's surviving spouse is the sole beneficiary,[56] the surviving spouse's life expectancy is recalculated during the surviving spouse's life. For calendar years after the calendar year of the spouse's death, generally the spouse's life expectancy is determined using the spouse's age as of the spouse's birthday in the calendar year of

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year rule would not have started taking distributions until the opportunity to switch arose, the IRS must have intended this to override the requirement that distributions must begin by December 31 of the year following the year of death.

[51] Letter Ruling 200811028.

[52] Reg. §§ 1.401(a)(9)-2(A-5) and 1.401(a)(9)-5(A-5), both under Code § 401(a)(9)(B)(i).

[53] Reg. § 1.401(a)(9)-5(A-5)(a)(2) and (c)(3). *See, e.g.*, Letter Ruling 200647029 when decedent died after the requiring beginning date and his children received separate inherited IRA accounts from his estate.

[54] Reg. § 1.401(a)(9)-5(A-5)(a)(1).

[55] Reg. § 1.401(a)(9)-5(A-5)(c)(3).

[56] The Final Regs use "sole beneficiary" instead of "sole designated beneficiary," but the terms seem to be used interchangeably. See text accompanying footnotes 32 and 33 for determining whether the surviving spouse is the sole beneficiary.

the spouse's death, and the spouse's life expectancy is reduced by one for each calendar year that has elapsed since the date of the spouse's death.[57] However, if the surviving spouse dies before the date upon which distributions are required to begin, the life expectancy to be used will be based on the beneficiaries who survived the (now deceased) surviving spouse.[58] Contrast these rules with the case if the surviving spouse were to roll over the account to her own IRA, in which case her RMDs would instead be calculated using the longer life expectancy set forth in the appendix (her life plus a hypothetical beneficiary ten years younger) rather than using her life expectancy alone. Furthermore, in the case of such a roll over, upon the surviving spouse's death, the children's life expectancies would apply, rather than using her remaining life expectancy. Only for compelling reasons should plan benefits not be left outright to the surviving spouse.

- If any other person's life expectancy is used, it is not recalculated; instead, that person's life expectancy is determined using that person's age as of that person's birthday in the calendar year immediately following the calendar year of the owner's death, and that person's life expectancy is reduced by one for each calendar year that has elapsed since the calendar year immediately following the calendar year of the owner's death.[59]

Key to applying the rules is the identity of the designated beneficiary, and hence the measuring life. Once all of these rules are satisfied and the beneficiary designation date has passed, the designated beneficiary's death has no effect. After the designated beneficiary's death, distributions will continue to be made over the designated beneficiary's remaining life expectancy, as determined previously above, even if somehow a beneficiary with a shorter life expectancy actually receives the benefits.[60]

The identification of the designated beneficiary for post-mortem RMDs is based on the beneficiaries designated as of September 30 of the calendar year following the calendar year of the owner's death (the "beneficiary designation deadline").[61] Consistent with the prior proposed regulations, the owner's estate does not qualify as a designated beneficiary;[62] however, a qualified revocable trust that elects to be taxed as an estate is not treated as an estate for purposes of the RMD rules. The preamble to the Final Regs states:[63]

> Commentators asked for clarification as to whether an election by a revocable trust to be treated as part of an estate under section 645

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[57] Reg. § 1.401(a)(9)-5(A-5)(c)(2).
[58] Reg. § 1.401(a)(9)-4(A-4)(b). This applies only if the owner died before the required beginning date.
[59] Reg. § 1.401(a)(9)-5(A-5)(c)(1).
[60] Reg. § 1.401(a)(9)-5(A-7)(c)(1).
[61] Reg. § 1.401(a)(9)-4(A-4)(a).
[62] Reg. § 1.401(a)(9)-4(A-3).
[63] Portion of the preamble entitled "Trust as Beneficiary."

> causes the trust to be treated as an estate for purposes of section 401(a)(9). On this point, the IRS and Treasury intend that a revocable trust will not fail to be a trust for purposes of section 401(a)(9) merely because the trust elects to be treated as an estate under section 645, as long as the trust continues to be a trust under state law.

Certain defects in beneficiary designations may be cured by the beneficiary designation deadline. The preamble to the Final Regs provides (emphasis added):[64]

> Some commentators requested that final regulations provide that, if the employee's estate was named as the beneficiary in the beneficiary designation or the employee's estate became beneficiary by operation of law, the beneficiary of the estate or the beneficiary of the IRA named under the employee's will could replace the estate as beneficiary by September 30 of the year following the year of death. This change is not being adopted in these final regulations. The period between death and the beneficiary determination date is a period during which beneficiaries can be eliminated but not replaced with a beneficiary ***not designated under the plan as of the date of death***. In order for an individual to be a designated beneficiary, any beneficiary must be designated under the plan or named by the employee as of the date of death.

Although the preamble states that the regulation prohibits the replacement of a beneficiary, it qualifies this by prohibiting replacement with a beneficiary "not designated under the plan as of the date of death." The Final Regs themselves are not quite as strict as the preamble might lead one to believe (emphasis added):[65]

> The fact that an employee's interest under the plan passes to a certain individual under a will or otherwise under applicable state law does not make that individual a designated beneficiary ***unless the individual is designated as a beneficiary under the plan***.

This implies that the plan can specifically provide that the fact that an owner's interest under the plan passes to a certain individual under a will or otherwise under applicable state law would make that individual a designated beneficiary under the plan as of the date of the owner's death. The author is not aware of other commentators suggesting this approach. The author encourages readers to request an IRS determination letter before incorporating this into their plans. If a plan were to adopt such a provision, it would need to require that the identity of any

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[64] Portion of the preamble entitled "Determination of the Designated Beneficiary."

[65] Reg. § 1.401(a)(9)-4(A-1).

such individual be determined no later than the beneficiary designation deadline. The plan might also specifically provide that the plan and its administrator will not be liable for relying on a fiduciary. An attorney drafting such a provision might want to consider specifying that such a fiduciary includes the personal representative of the decedent's estate (if the estate is the beneficiary before considering this provision) and the trustee of a trust under the terms of which the plan benefits are to pass (in situations involving a pour-over will, the plan administrator might need certifications from both). Try to avoid using the word "executor" unless you first read and draft around Code § 2203 and the regulations thereunder.

The Final Regs require that a disclaimer must satisfy the Code § 2518 disclaimer rules.[66] The same provision also requires that the disclaimer be made by the beneficiary designation deadline, but the nine-month deadline in the Code § 2518 disclaimer rules means that all qualified disclaimers would be made by the beneficiary designation deadline. To maximize the possibility of success, such cures should be expressly authorized in the beneficiary designation or under the plan.

Disclaiming RMDs

Minimum distributions pose a particular problem in the year of death. Suppose a beneficiary is considering whether to disclaim, but the beneficiary cannot decide before a distribution is required at the end of the year?

Fortunately, Revenue Ruling 2005-36 provides guidance in three situations under the following scenario: Decedent dies in 2004. At the time of death, Decedent is the owner of an IRA described in § 408(a) with assets having a fair market value of $2,000x. Decedent's "required beginning date," as described in § 401(a)(9)(A), occurred before 2004, and accordingly Decedent was receiving annual distributions from the IRA prior to the time of death. However, at the time of death, Decedent had not received the required minimum distribution for the 2004 calendar year.

Situation 1

Under the terms of the IRA beneficiary designation pursuant to the IRA governing instrument, Decedent's spouse, Spouse, is designated as the sole beneficiary of the IRA after Decedent's death. *A*, the child of Decedent and Spouse, is designated as the beneficiary in the event Spouse predeceases Decedent. Three months after Decedent's death, in accordance with § 1.401(a)(9)-5, A-4, of the Income Tax Regulations, the IRA custodian pays Spouse $100x, the required minimum distribution for 2004. No other amounts have been paid from the IRA since Decedent's date of death.

Seven months after Decedent's death, Spouse executes a written instrument pursuant to which Spouse disclaims the pecuniary amount of $600x of the IRA account balance plus the income attributable to the $600x amount earned after the date of death. The income earned by

[66] Reg. § 1.401(a)(9)-4(A-4)(a).

the IRA between the date of Decedent's death and the date of Spouse's disclaimer is $40x. The disclaimer is valid and effective under applicable state law. Under applicable state law, as a result of the disclaimer, Spouse is treated as predeceasing Decedent with respect to the disclaimed property. As soon as the disclaimer is made, in accordance with the IRA beneficiary designation, *A*, as successor beneficiary is paid the $600x amount disclaimed, plus that portion of IRA income earned between the date of death and the date of the disclaimer attributable to the $600x amount ($12x).

The IRS ruled that, assuming the other requirements of a qualified disclaimer are satisfied, Spouse's disclaimer constitutes a qualified disclaimer under § 2518(b) of the $600x pecuniary amount, plus $12x (the IRA income attributable to the disclaimed amount ($600x/$2000x X $40x)).

<u>Situation 2</u>

The facts are the same as in Situation 1, except that, instead of disclaiming a pecuniary amount, Spouse validly disclaims, in the written instrument, 30 percent of Spouse's entire interest in the principal and income of the balance of the IRA account remaining after the $100x required minimum distribution for 2004 and after reduction for the pre-disclaimer income attributable to the $100x required minimum distribution ($2x). As soon as the disclaimer is made, in accordance with the beneficiary designation, *A* is paid 30 percent of the excess of the remaining account balance over $2x.

The IRS ruled that, assuming the other requirements of a qualified disclaimer are satisfied, Spouse's disclaimer of 30% of Spouse's entire interest in the principal and income of the balance of the IRA account remaining after the $100x required minimum distribution for 2004 and after reduction for the pre-disclaimer income attributable to that amount ($2x), constitutes a qualified disclaimer to the extent of 30 percent of the remaining IRA account balance after reduction for the $2x of income Spouse is deemed to have accepted (that is, 0.30 multiplied by [the value of the remaining account balance on date of disclaimer - $2x]).

<u>Situation 3</u>

The facts are the same as in Situation 1, except that *A* is designated as the sole beneficiary of the IRA after Decedent's death, Spouse is designated as the beneficiary in the event *A* predeceases Decedent, and the $100x required minimum distribution for 2004 is paid to *A* 3 months after Decedent's death. Seven months after Decedent's death, *A* disclaims the entire remaining balance of the IRA account except for $2x, the income attributable to the $100x required minimum distribution paid to *A*. As soon as the disclaimer is made, in accordance with the IRA beneficiary designation, the balance of the IRA account, less $2x, is distributed to Spouse as successor beneficiary. *A* receives a total of $102x.

<u>Analysis</u>

The IRS stated that, in Situations 1, 2, and 3, the beneficiary's receipt of the $100x distribution from the IRA constitutes an acceptance of $100x of corpus, plus the income attributable to that amount. Based on the formula contained in Reg. § 25.2518-3(c), the amount of income attributable to the $100x distribution that the beneficiary is deemed to have accepted, and therefore cannot disclaim, is $2x computed as follows:

- $40x (IRA income from date of death to date of disclaimer), multiplied by
- $100x (distribution), divided by
- $2000x (date of death value of IRA).

However, the IRS reasoned, the beneficiary's acceptance of these amounts does not preclude the beneficiary from making a qualified disclaimer with respect to all or a portion of the balance of the IRA.

The IRS pointed out that the results in Situations 1 and 2 would be the same if the amount disclaimed, plus that portion of the post-death IRA income attributable to the disclaimed amount, is not distributed outright to *A*, but instead is segregated and maintained in a separate IRA account of which *A* is the beneficiary as described in Reg. § 1.401(a)(9)-8, A-3. *See also* Reg. § 1.401(a)(9)-8, A-2(a)(2). Separate accounts for *A* and Spouse may be made effective as of the date of Decedent's death in 2004, and the 2004 required minimum distribution does not have to be allocated among the beneficiaries of the separate accounts for purposes of the separate account rules under Reg. § 1.401(a)(9)-8, A-3.

Finally, the IRS summarized the ruling by stating that the beneficiary receiving the required minimum distribution for the year of the decedent's death from the IRA will not preclude a qualified disclaimer. The beneficiary may make a qualified disclaimer with respect to all or a portion of the balance of the account, other than the income attributable to the required minimum distribution that the beneficiary received, provided that at the time the disclaimer is made, the disclaimed amount and the income attributable to the disclaimed amount are paid to the beneficiary entitled to receive the disclaimed amount, or are segregated in a separate account.

Further, the IRS stated, a person disclaiming his or her entire remaining interest in an IRA will not be considered a designated beneficiary of the IRA for purposes of Code § 401(a)(9), if the qualified disclaimer is made on or before September 30 of the calendar year following the calendar year of the employee's death, and if, on or before that September 30th, the disclaimant is paid the income attributable to the required minimum distribution amount, so that the disclaimant is not entitled to any further benefit in the IRA after September 30th of the calendar year following the calendar year of the employee's death.

Separate Account Rules

If more than one person is a designated beneficiary, the beneficiary with the shortest life expectancy is the measuring life.[67] However, the beneficiaries of separate accounts are considered separately.[68] A separate account in an individual account is a portion determined by

[67] Reg. § 1.401(a)(9)-5(A-7)(a)(1).
[68] Reg. § 1.401(a)(9)-5(A-7)(a)(2).

an acceptable separate accounting from the date of the owner's death, including allocating all post-mortem investment gains and losses on a pro rata basis in a reasonable and consistent matter between such portion and the owner's other benefits.[69] Granting a person a percentage interest in an IRA qualified as establishing a separate account for that person under Letter Ruling 200121073 (1987 proposed regulations), and the author believes that the same result would occur the Final Regs.

The Final Regs clarify that the accounting for separate accounts must account for post-mortem activity, whereas under the 2001 proposed regulations it could have been argued that this accounting must also cover activity while the owner is living.

Here are some more important points to the separate account rule:

- The fact that an owner's interest under a plan passes to a certain individual under state law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan.[70] This disregard for the facts of state law in determining beneficiary designations may also signal a disregard for a separate accounting unless the plan or beneficiary designation provides for separate accounts.[71] Thus, it would be prudent for a beneficiary designation to provide that each beneficiary's share shall be accounted for separately or held in a separate account. Below, we will see that special separate account language is necessary when referring to a trust in a beneficiary designation.[72]

- Although the possible designated beneficiaries are determined on the beneficiary designation deadline, the separate account rules can narrow the identity of the beneficiaries. The applicable distribution period for each separate account is determined disregarding other beneficiaries if, and only if, the separate account is established no later than the December 31 following the beneficiary designation deadline (the "division deadline").[73] For example, if a separate account where the surviving spouse is the sole beneficiary is established by the division deadline, distributions from that account can be delayed until the owner would have attained age 70½, even if other separate accounts under the plan must begin distributions at an earlier date.[74] Similarly, distributions from a separate account established by the division deadline may be made using the life expectancy of that account's

[69] Reg. § 1.401(a)(9)-8(A-3)(a).
[70] See text accompanying footnotes 61-62.
[71] The second clause of the first sentence of Reg. § 1.401(a)(9)-8(A-2)(a) applies "if an employee's benefit under a defined contribution plan is divided into separate accounts *under the plan*" (emphasis added), implying that it may be necessary for the plan to authorize separate accounts.
[72] See text following the text accompanying footnote 80.
[73] Reg. § 1.401(a)(9)-8(A-2)(a)(2)(third sentence).
[74] *Id.* (fourth sentence).

beneficiary, even if distributions from other separate accounts under the plan with different beneficiaries are being made under the 5-year rule.[75]

- If separate accounts are established after the division deadline, they will not be recognized for the purpose of determining their measuring lives. However, they will be separately tested regarding whether they met their RMDs.[76]

Drafting Beneficiary Designations Involving Trusts

Owners often find it advantageous to designate a trust as a beneficiary of a plan; however, the Final Regs lay traps for the unwary. Before discussing rules for drafting trusts, consider how the beneficiary designation itself should be drafted. Fractional bequests are less risky than pecuniary bequests.[77] As under prior rules, a trust is not a designated beneficiary, but its beneficiaries may be.[78] The life expectancy of each person who is considered a designated beneficiary is considered, and the least favorable life expectancy is used. In contrast to Letter Ruling 200218039 under the 1987 proposed regulations,[79] the separate account rules do not apply to beneficiaries of a trust if the trust itself is named as the beneficiary.[80] Under the 2001 proposed regulations, beneficiaries could be eliminated by almost any means, so arguably this was not a very important issue, but the Final Regs are not as liberal in how to eliminate beneficiaries (discussed later below). This might undermine planning if a revocable trust has as a beneficiary a disqualified person (such as a charity) or an individual who is older than the individuals who ultimately receive the benefits. To avoid this issue, the author's beneficiary designations used to read "beneficiaries under [residual clause] of the [name of trust], to be held in a separate account for each beneficiary." To help support the author's argument that this merely incorporates by reference the revocable trust, the owner may want to attach a copy of the trust to the beneficiary designation form. The author views this as just an added precaution, since providing such a copy would be significantly before the documentation deadline discussed below.[81] However, the author is now using beneficiary designations similar to those provided in Appendix C. You might find Letter Ruling 200537044 helpful.[82]

In addition to the above factors, additional language in a beneficiary designation might provide for the beneficiary to control the account and be able to designate beneficiaries. Such language could include: "Each beneficiary (or trustee of a trust created for a beneficiary, subject to the limitations of such trust) may manage such separate account and name one or more

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[75] *Id.* (fifth sentence). For a summary of the 5-year rule, see the text accompanying footnote 46.
[76] *Id.* (first three sentences).
[77] C.C.A. 200644020 held that assigning an IRA in satisfaction of a pecuniary bequest was taxable even though the IRA had not made distributions to the pecuniary beneficiary.
[78] Reg. § 1.401(a)(9)-4(A-5)(a).
[79] See text accompanying footnote 13.
[80] Reg. § 1.401(a)(9)-4(A-5)(c).
[81] See the text accompanying footnote 85.
[82] The author wishes the IRS would have issued this Letter Ruling as a Revenue Ruling instead, so that we could rely on it definitively.

beneficiaries." This language attempts to provide flexibility that may or may otherwise be provided in the IRA agreement itself, and even if the IRA agreement had such flexibility, one never knows when the custodian will modify the IRA agreement.

For a trust's beneficiaries to be designated beneficiaries, all four of the following requirements must be met:[83]

- The trust is valid under state law, or would be but for the fact that there is no corpus.
- The trust is irrevocable or will, by its terms, become irrevocable upon the owner's death.
- The trust's beneficiaries who have an interest in the plan are identifiable from the trust instrument (discussed below).
- Documentation is provided to the plan administrator.

The IRA trustee, custodian, or issuer is treated as the IRA's plan administrator.[84] Either a copy of the trust or a list of the trust's beneficiaries (which list is as of the beneficiary designation deadline), must be delivered to the plan administrator by the October 31 following the beneficiary designation deadline;[85] however, to facilitate transition, this deadline has been extended to October 31, 2003 for owners dying before 2002.[86]

Drafting Trusts - Generally

After complying with the above rules, our inquiry is not over. We must consider restrictions on beneficiaries for a trust to qualify as a designated beneficiary. Appendix B summarizes the rules for drafting trusts. Below is a more detailed discussion of these rules.

Drafting Trusts – The Importance of Restricting Beneficiaries

The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible, as of the date the beneficiary is being determined, to identify the class member with the shortest life expectancy.[87] If the trust is a conduit trust, with all plan benefits received by the trust being paid directly to one beneficiary upon receipt by the trustee, then the other beneficiaries are disregarded.[88] Otherwise, contingent beneficiaries are considered,[89] even if their contingencies are farfetched.

[83] Reg. § 1.401(a)(9)-4(A-5)(b).
[84] Reg. § 1.408-8(A-1)(b).
[85] Reg. § 1.401(a)(9)-4(A-6)(b).
[86] Reg. § 1.401(a)(9)-1(A-2)(c).
[87] Reg. § 1.401(a)(9)-4(A-1).
[88] Reg. § 1.401(a)(9)-5(A-7)(c)(3), Example 2, illustrates this interpretation of the conduit rule.
[89] Reg. § 1.401(a)(9)-5(A-7)(b), (c)(3), Example 1.

How to eliminate beneficiaries becomes a issue key issue when the trust's beneficiaries are too expansive. The Final Regs provide generally that "the employee's designated beneficiary will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the employee's death."[90] Then they provide that a beneficiary may be eliminated by receiving all of her benefits under the plan or by disclaiming. Regarding receiving benefits under the plan, the Final Regs provide: [91]

> Consequently, except as provided in §1.401(a)(9)-6T, any person who was a beneficiary as of the date of the employee's death, but is not a beneficiary as of that September 30 (e.g., because the person receives the entire benefit to which the person is entitled before that September 30), is not taken into account in determining the employee's designated beneficiary for purposes of determining the distribution period for required minimum distributions after the employee's death.

Regarding qualified disclaimers, the Final Regs provide: [92]

> Accordingly, if a person disclaims entitlement to the employee's benefit, pursuant to a disclaimer that satisfies section 2518 by that September 30 thereby allowing other beneficiaries to receive the benefit in lieu of that person, the disclaiming person is not taken into account in determining the employee's designated beneficiary.

Are those merely examples of how to eliminate a beneficiary, or are they the only way to eliminate a beneficiary? The preamble states that a disclaimer must be qualified to be recognized.[93] This contrasts with the same part of the 2001 preamble, stating that beneficiaries could be eliminated "by distribution of the benefit or through disclaimer (or otherwise)…." The changes to the preamble and regulations seemingly represent a significant narrowing of the IRS' view on how to eliminate a beneficiary. On the other hand, it is possible that the IRS thought that it was simply clarifying what type of disclaimer is acceptable, which provides certainty to plan administrators in allowing them to rely on a federal tax law concept. Consider how preamble to the 2001 proposed regulations described eliminating beneficiaries:[94]

> The 2001 proposed regulations provided that, generally, the designated beneficiary is determined as of the end of the year following the year of the employee's death. Thus, any beneficiary eliminated by distribution of the beneficiary's benefit or through

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[90] Reg. § 1.401(a)(9)-4(A-4)(a)(first sentence).
[91] The second sentence of Reg. § 1.401(a)(9)-4(A-4)(a).
[92] The third sentence of Reg. § 1.401(a)(9)-4(A-4)(a).
[93] Second paragraph of the preamble entitled "Determination of the Designated Beneficiary."
[94] First paragraph of the preamble entitled "Determination of the Designated Beneficiary."

> disclaimer during the period between the employee's death and the end of the year following the year of death is disregarded in determining the employee's designated beneficiary for purposes of calculating required minimum distributions.

Either the IRS did not remember the "or otherwise" parenthetical in the text above, or it viewed that parenthetical as simply authorizing nonqualified disclaimers. This leaves a big hole regarding court modifications of trusts. Are court modifications of trusts acceptable because they receive some official recognition that provides comfort to the plan administrator (court approval), and nonqualified disclaimers are not acceptable because they receive neither official recognition by a court nor retroactive recognition under the federal tax laws? Or are court modifications of trusts to be viewed as merely another version of a nonqualified disclaimer?

Drafting Trusts – Deciding How to Restrict Beneficiaries to Satisfy the RMD Rules

After deciding who the beneficiaries are under an existing trust, let's return to a discussion of how to draft trusts. If the beneficiary has the power to withdraw all of the trust's assets when the trust is established, then all distributions to the trust will be treated for income tax purposes as if they were made directly to the beneficiary. A beneficiary who is a U.S. citizen or resident is treated as the owner of a portion of a trust over which the beneficiary has the power "to vest the corpus or income therefrom in himself."[95] The beneficiary includes on his individual income tax return any income attributable to that portion of the trust of which he is the owner.[96] Thus, the trust should qualify as a conduit trust.[97] The Proposed Regs do not specifically address a withdrawal right trust. The most prudent course would be to draft even that trust as a conduit trust, because other provisions in the Final Regs give the author the impression that the IRS may argue with this result. For example, if the surviving spouse is the sole beneficiary of an IRA and has the unlimited right to withdraw from the IRA, the spouse may treat the IRA as his or her own IRA.[98] However, if a trust is named as the beneficiary, the surviving spouse may not make this election, even if the spouse is the sole beneficiary of the trust. What happens if the spouse also has an unlimited right to withdraw the trust's assets? Traditionally, the IRS has allowed a surviving spouse to roll over such assets. The IRS' view in this regulation is a little perplexing, in that there seems to be no reason why a spouse who could withdraw the IRA from the trust and roll it over would not also be able to characterize it as the spouse's own IRA. To a certain

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[95] Code § 678(a)(1), as limited by Code § 678(f).
[96] Code § 671. See Choate, "When A "Trust For The Spouse" Is Treated As The Same As The Spouse," September 2001 *Trusts and Estates*, pages 36, 44 (portion entitled, "Sec. 678 Grantor Trust Should be Same as "the Spouse").
[97] See Letter Ruling 199903050, which ruled that a beneficiary who was a surviving spouse was deemed the sole beneficiary of the portion she could withdraw. Under the Final Regs, see Letter Ruling 200346025, allowing the surviving spouse to roll over when she had the right to withdraw all of the trust's assets.
[98] Reg. § 1.408-8(A-5)(a).

extent, the preamble to the Final Regs clarifies the IRS' views on this:[99] "If the spouse actually receives distribution from the IRA, the spouse is permitted to roll that distribution over within 60 days into an IRA in the spouse's own name to the extent that the distribution is not a required distribution, regardless of whether or not the spouse is the sole beneficiary of the IRA owner." Thus, the IRS expects the surviving spouse to roll over an IRA from a trust if the surviving spouse is to characterize the IRA as her own.[100]

If that type of trust poses uncertainty, how about a slightly more restrictive trust? A common scenario might be a trust providing for discretionary distributions at any age, mandatory distributions at various ages, and then termination and distribution to the beneficiary when the beneficiary attains a particular age. For example, a trust makes discretionary distributions generally, subject to mandatory payments of one-third at age 25, one-half at age 30, and the balance at age 35. As described later below,[101] age 35 is well below the beneficiary's life expectancy. However, it is possible that the trustee may accumulate distributions from the plan, and that such accumulations pass to the remaindermen. It also common to include a contingent general power of appointment so that no GST tax is imposed on the beneficiary's death, in case the original grantor did not have enough GST exemption to shield the trust from GST tax when it passes from a child to that child's children. If the remaindermen are to be considered, then the general power of appointment will cause the trust not to have a designated beneficiary. Because the Final Regs do not provide any examples to assure taxpayers that the remaindermen of this trust will be disregarded, using a conduit trust seems a prudent way to draft.

A conduit trust for a child is not always a good idea, especially if the beneficiary's life expectancy is not being used. For example, suppose a retirement plan were left in trust for the surviving spouse, either because of a second-marriage situation or a lack of faith in the surviving spouse's ability to make wise financial decisions. Upon the surviving spouse's death, her remaining life expectancy would be used.[102] Her remaining life expectancy may not be a very long period of time, forcing assets out of a conduit trust for a child significantly before the beneficiary attains the desired age.

When drafting a lifetime trust so that it falls within the designated beneficiary rules, should the trust be a conduit trust, or should the beneficiaries be limited? The answer depends on the primary beneficiary and why the trust is a lifetime trust. For bequests to <u>marital deduction</u>

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[99] The third paragraph of the portion of the preamble titled "Election of Surviving Spouse to Treat Inherited IRA as Spouse's Own IRA."

[100] Rollovers from qualified plans are permitted only if the surviving spouse has an unlimited power to withdraw the trust's assets. Letter Ruling 9145041. Also, although generally a rollover from a qualified plan cannot be made to an inherited IRA, a surviving spouse who is the sole beneficiary may set up an inherited IRA to avoid the 10% penalty tax that might otherwise have been imposed for distributions before the surviving spouse attained age 59½. Letter Ruling 200450057. The same concept applies if the decedent's account is an IRA. Letter Ruling 200532060.

[101] See text accompanying footnote 106.

[102] See text accompanying footnote 57.

trusts, attorneys should consider estate planning aspects of marital trusts, as well as the income deferral that may be available.

Conduit provisions become more appealing in drafting marital trusts, since the surviving spouse is the only beneficiary during the surviving spouse's life. A conduit trust also permits the surviving spouse's life expectancy to be recalculated annually. Also, if the decedent did not survive the required beginning date, RMDs may be delayed until the end of the calendar year in which the decedent would have attained age 70½, although the marital deduction rules may require the account's internal income to be distributed. Finally, marital trusts require all income to be distributed to the surviving spouse no less frequently than annually, and the IRS' safe harbor for a marital trust requires the surviving spouse to have the option of requiring the trustee to withdraw the IRA's current income.[103] Rev. Rul. 2006-26 provides guidance in determining fiduciary accounting income. Here are some wrinkles in marital trusts:

- What happens if the surviving spouse does not require the trustee to withdraw the plan's income from the plan – does that constitute a gift by the surviving spouse to the remaindermen? A solution may be to provide that, if the surviving spouse does not demand the distribution, then the trustee is required to distribute an amount equal to the plan's income but may choose to withdraw this amount from the plan or to use trust principal to satisfy this distribution. Providing the surviving spouse with a power of appointment may suffice, in that the lapse of the right to withdraw income would constitute an incomplete gift. However, an incomplete gift would cause estate inclusion, which would cause an unexpected tax result if the personal representative elected to use the trust as a credit shelter trust. With the credit against estate tax continuing to increase, it has become attractive in many situations to draft one trust that could be used as a marital trust or credit shelter trust, and let the personal representative elect the extent to which such a trust serves as either type of trust. Also, an incomplete gift could also constitute an addition that would partially undo a trust's exemption from generation-skipping transfer taxes.

- Granting the surviving spouse the power to withdraw from the trust's IRA may be necessary. Some might attempt to rely on the Missouri income and principal rules,[104] which allocate to income any payment the trustee receives that constitutes internal plan income. This law allocates to income only receipts equal to the plan's income – it does not allocate to income any plan income that is not actually distributed. It may be possible that giving the surviving spouse the power to require the trustee to make the plan productive, combined this rule, may be sufficient to comply with the IRS' safe harbor. However, this author prefers to give the spouse the power to withdraw the plan's internal income to meet the literal terms of the safe harbor.

[103] Rev. Rul. 2000-2.

[104] R.S.Mo. **§** 469.437 appears to satisfy the requirements of Rev. Rul. 2006-26 for determining fiduciary accounting income. However, Rev. Rul 2006-26 assumed that the trust used Rev. Rul. 2000-2 safe harbor of allowing the surviving spouse to require the trustee to withdraw all income.

From an income tax deferral perspective, outright distributions are better than bequests to marital trusts. With outright distributions, the surviving spouse can roll over the account and take distributions using the table set forth in Appendix A.[105] Thus, one or both of the following reasons usually motivates bequests to a marital trust: the owner does not have confidence that the surviving spouse will manage the account properly, or the owner wants to preserve the account for the remaindermen (e.g., a second marriage). If lack of confidence is the sole reason, a conduit trust may very well be desirable, because it minimizes RMDs and allows the trustee to manage the assets and pay them out over the surviving spouse's recalculated life expectancy. If preservation of the account is the sole reason, a conduit trust could defeat the goals of preserving the assets for the remaindermen unless the surviving spouse dies before the RMDs significantly exceed the account's internal income.

For bequests to trusts for beneficiaries other than surviving spouses, a lifetime trust usually is motivated by one or both of the following reasons: the owner does not have confidence that the beneficiary will manage the account properly, or the owner wants to preserve the account for the remaindermen (e.g., generation-skipping transfer considerations). If lack of confidence is the sole reason, a conduit trust may very well be desirable, because it minimizes RMDs and allows the trustee to manage the assets and pay them out over the beneficiary's life expectancy without being concerned about cutting back any power of appointment granted to the beneficiary. If preservation of the account is the sole reason, it may be desirable to (a) limit the trustee's authority to make distributions so that distributions may be made only to the beneficiary or his or her descendants, and (b) limit the beneficiary's power of appointment to appointees who are not older than the beneficiary.

Below is an example of how to apply these rules to a common situation. Suppose Harry and Wanda have been married for many years, their first and only marriage. They have two children, Sam and Dolly. Harry and Wanda have the highest trust in each other and their children. Harry leaves his IRA outright to Wanda, but provides that the IRA will pass to a credit shelter trust if and to the extent that Wanda disclaims. How should the credit shelter trust and bequest to descendants be handled?

- The <u>credit shelter trust</u> provides for distributions for the support of Wanda and of their descendants, granting Wanda a testamentary power of appointment to their descendants, their spouses and charities. When Wanda disclaims her interest in the IRA, she must necessarily disclaim her power of appointment in the credit shelter trust.

  - If the credit shelter trust is a conduit trust with respect to the IRA assets only, Wanda's life expectancy is calculated without regard to the remaindermen, and Wanda's remaining life expectancy will be used upon her death (assuming they are the remaindermen). Since the purpose of Wanda's disclaiming was to preserve assets passing free from estate tax at Wanda's death, it is unlikely that a conduit trust would meet this objective, unless Wanda dies before distributions

[105] See text accompanying footnote 57.

accelerate in her older years. On the other hand, since the trust is taxed at the highest marginal income tax rate and the IRA distributes only ordinary income, a conduit trust could save income tax if Wanda's marginal tax rate is low. The author would tend not to use a conduit trust if there is a large possibility of estate tax on Wanda's estate (for estate tax purposes, not probate purposes) at her death; instead, the author would manage income taxes through distributions for Wanda's support. On the other hand, if Wanda really needs the IRA distributions to support herself, a conduit trust would make sense. This situation might occur if Wanda's own assets are valuable but do not provide enough income to meet her living needs. It would not occur if her assets are not very valuable, because in that case she would roll over the IRA into her own.

- ➢ If the credit shelter trust is not a conduit trust, Wanda's non-recalculated life expectancy will be used, but please pay careful attention to who the remaindermen would be. Regarding who may be remaindermen, see below regarding the rules if Wanda does not survive Harry.

- The <u>bequest to descendants</u>, either on Harry's death or upon termination of the credit shelter trust, could be outright or in trust. If the children receive the IRA outright, no further complications should arise. If any child's share would be held in a trust, then drafting the trust depends on whether that child's trust is created at Harry's death or at Wanda's death.

  - ➢ If a child's trust is created at Harry's death, the children's trust should either be a conduit trust or have limits so that distributions, either directly or through the exercise of that child's power of appointment, may be made only to individuals no older than that child or to other trusts that satisfy these requirements. If the trust were a lifetime trust not protected by Harry's GST exemption, then the beneficiary would typically be given a general power of appointment (usually a contingent power). Ordinarily, a contingent general power of appointment would disqualify the trust as a designated beneficiary, so such a trust must be drafted as a conduit trust. If Harry provides for such a lifetime trust for Sam, it is merely for protection from creditors or Sam's spouse, so Harry should not mind if the trust is a conduit trust.

  - ➢ If a child's trust is created at Wanda's death, two possibilities exist. If the trust's assets came from Wanda's plan, then rules apply that are similar to the case when a child's trust is created at Harry's death. If the trust's assets came from the credit shelter trust, and the credit shelter trust was a conduit trust, then the child's trust can be drafted without considering any of these rules. If the trust's assets came from the credit shelter trust, and the credit shelter trust was not a conduit trust, then rules apply that are similar to the case when a child's trust is created at Harry's death.

If the client has difficulty deciding what to do, consider giving an independent third party the right to amend the trust. Letter Ruling 200537044 approved allowing a "trust protector" to amend a trust from a conduit trust to a limitation-of-beneficiaries trust and vice versa no later than September 30 following the year of the owner's death. The author does not recommend relying on Letter Ruling 200537044, not only because its lack of precedential value but also because the original revocable trust did not have correct limitation on beneficiary language and required fixing by the trust protector. Instead, the trustee (who is not the beneficiary) should have a choice between two properly drafted trusts, one a conduit trust and another a limitation on beneficiary trust. Choosing between these two trusts would merely be a way of eliminating a beneficiary.

How to Draft a Conduit Trust

The author is unhappy that conduit trusts are the only safe harbor in certain circumstances, but let's play the hand we have been dealt. Using a conduit trust is not such a bad result if the primary beneficiary's life expectancy is being used. Under the Final Regs, each person has a life expectancy of at least 82.4 years,[106] which is a 1.2% withdrawal the first year. That increases to the following initial percentages if the beneficiary has attained the following age in the year following the year of the owner's death:

Age	16	33	51	60	66
Percentage	1.5%	2%	3%	4%	5%

As a practical matter, the percentage distributions will be small compared to a trust's total return.

If a beneficiary foolishly spends the money from these distributions before the owner otherwise would have preferred, substantially all of the trust remains intact until the beneficiary attains a mature age.

Below is some language that an attorney might want to add to make a trust a conduit trust, with footnotes providing the reasons for certain provisions:

> If the trust is the beneficiary of any qualified retirement plan or individual retirement account or annuity (a "Retirement Account") subject to Code section 401(a)(9) or comparable provisions (the "Minimum Distribution Rules"), the trustee shall withdraw from the Retirement Account no less than the amount required under the Minimum Distribution Rules.[107] If and to the extent necessary to enable the Retirement Account to

[106] Reg. § 1.401(a)(9)-9(A-1).

[107] Many trusts use ascertainable standards. One might want to make sure there is no penalty for failure to take distributions. Many states, including Missouri, have provisions limiting the amount that a trustee may distribute to himself. The author advises an attorney using this provision to consult applicable state law and opt out of such laws, by specific reference to them, to the extent that such attorney deems necessary. Other parts of the author's estate planning documents specifically opt out of RSMo. § 456.8-814.2, so the author has not repeated them here.

> use the beneficiary's life expectancy under the Minimum Distribution Rules without considering the identity or life expectancy of any other beneficiary (whether current or future, vested or contingent) of the trust,[108] the trustee shall distribute directly[109] to the beneficiary each withdrawal from a Retirement Account, whether or not such withdrawal is required under the Minimum Distribution Rules.

The author does not represent that the above language will work – it is just a compilation of ideas for a competent attorney to analyze independently.

For multiple beneficiaries, the last sentence of the sample language above would be changed to remove "the beneficiary" and insert the class of beneficiaries. Additional language would state that, to the extent the extent that such distributions exceed each beneficiary's support (or whatever distribution standard the drafter uses), the excess would be distributed equally among the beneficiaries (or in some other fixed proportion the client prefers).

How should the trust pay its expenses, such as trustee and tax preparation fees, if the Retirement Account is the trust's only asset? The IRS has not provided any precedential guidance on this issue; however Letter Ruling 200537044 approved a trust as a conduit trust when withdrawals from retirement assets were required to be distributed to the beneficiary as soon as possible after expenses directly related to the retirement plan are deducted.[110] Any payment of expenses introduces some level of risk in this area, and the trustee should not be authorized to pay expenses relating to other assets.[111] As a practical matter, the trustee should be able to withdraw funds from the Retirement Account to pay expenses relating to the Retirement Account. Let's return for a moment to the theory behind the conduit trust. The conduit concept eliminates from consideration a beneficiary if that beneficiary is merely a successor to the current beneficiary's interest, and the trust cannot accumulate distributions from the Retirement Account for the benefit of that successor beneficiary.[112] If the trustee uses distributions from the Retirement Account to pay current expenses relating to the Retirement Account, the trustee is not accumulating distributions from the Retirement Account for the benefit of any successor beneficiary. An attorney who is concerned about this issue might consider the following approaches:

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[108] If the five-year rule applies, then this first condition is not satisfied, and the trust would not be a conduit trust. Otherwise, the whole account would need to distributed to the beneficiary within five years, destroying the purpose of holding the property in trust.

[109] All benefits must be paid directly to the beneficiary. See text accompanying footnote 32. The author's forms include a facility of payment clause that authorizes payments to custodial accounts.

[110] It has been suggested that this letter ruling generally approved of paying trust expenses. If and to the extent that might be true, it was a meaningless holding, in that the trust's language said that such expenses could be paid only to the extent they do not ruin the use of the beneficiary's life expectancy.

[111] See text accompanying footnotes 116-117.

[112] Reg. § 1.401(a)(9)-5(A-7)(c)(1).

- Leave the sample conduit trust language alone. The sample language requires distributions directly to the beneficiary "[i]f and to the extent necessary to enable the Retirement Account to use the beneficiary's life expectancy…." The trustee could determine that using the Retirement Account's assets to pay expenses relating to the Retirement Account is something that does not prevent the Retirement Account from using the beneficiary's life expectancy. The trustee would probably decide to distribute all of the RMDs to the beneficiary, so as a practical matter the beneficiary's only complaint might be that future distributions would be lower than because the expenses were paid from the Retirement Account. An attorney drafting the trust would need to use his or her own judgment to determine whether a court would find a trustee liable for paying trust expenses from a Retirement Account when that is the only source of paying those expenses.

- Specifically authorize expenses relating to the Retirement Account to be taken directly from the Retirement Account. From the viewpoint of the RMD rules, this approach introduces some additional tax risk. However, such a provision may be necessary to induce a trustee to serve. An estate planner might conclude that the practicalities of the trustee's administrative duties outweigh any tax risk, especially if the planner believes that the analysis above in support of paying such expenses is persuasive enough.

How to Draft a Trust That Is Not a Conduit Trust

As discussed below, trusts that are not conduit trusts require limitations on beneficiaries that might not otherwise be part of a client's desired estate plan. If the client is willing to accept a dual-track dispositive plan to meet the RMD rules, instead of doubling the number of trusts in the agreement the attorney might want to consider providing that any distributions from retirement accounts be made either directly to the primary beneficiary or to a separate account whose dispositive provisions include these limitations.

If the trustee has the power to sprinkle among beneficiaries, then the beneficiary with the shortest life expectancy must be identifiable. Between the primary beneficiary and the primary beneficiary's descendants, hopefully the IRS will accept the proposition that a parent must be older than her child (although presumably the IRS could try to concoct a situation in which the parent adopts a person who is older than the adopting parent). However, it is very possible that the primary beneficiary's spouse may be older than the primary beneficiary. Thus, it may be prudent for the trust agreement not to authorize distributions to the primary beneficiary's spouse, although the trust agreement simply could preclude distributions to a primary beneficiary's spouse who is older than the primary beneficiary. If it is desirable to name the primary beneficiary's spouse as a beneficiary of a sprinkle trust, then it may be advisable for the trust to require separate accounting for any retirement plan benefits and provide that those benefits will not be available for distribution to the primary beneficiary's spouse.

Be careful regarding contingent remaindermen. If property passes through trusts at all levels, the ultimate beneficiaries for whom benefits might be accumulated in trust must be individuals who are not older than the desired beneficiary. A contingent bequest to the grantor's heirs might not work because the heirs living at the time of the grantor's death may be too old.

However, if a trust terminates outright in favor of a beneficiary, then any contingent beneficiary taking if that beneficiary does not survive would probably be considered a "successor beneficiary" whose interest may be ignored.[113]

If the primary beneficiary holds an inter vivos power of appointment, the class in favor of whom the power of appointment could be exercised should be limited to individuals who are not older than the primary beneficiary. The same principles apply if the primary beneficiary holds a testamentary power of appointment.

If a trust is modified through a qualified disclaimer, that modification should be respected **if** the beneficiary designation under the plan authorizes disclaimers. However, caution is advised, as qualified plans do not always recognize disclaimers.[114] Furthermore, suppose the trust for a child followed a trust for the spouse. Any disclaimer relating to the trust for the child must be made at the first spouse's death, even if the surviving spouse had a power of appointment.[115] The author does not understand the policy reason for requiring disclaimers by remainder beneficiaries upon the first spouse's death when the surviving spouse has a power of appointment that makes any remainder interest contingent and extremely uncertain as to amount (if any) and terms. The author would provide strong moral support to a reader who wants to take action to change this regulation.

To the extent that there are other assets available to pay estate taxes, retirement plan benefits should not be available to pay estate tax.[116] A favorable 2002 IRS Letter Ruling involving a revocable trust was based on the fact that IRA proceeds were not to be "applied to the payment of marital and charitable bequests, debts, or administration expenses required to be funded by" the trust. [117]

Meeting the RMD Rules Through an Annuity Purchase [118]

Much attention has been paid to "stretch IRAs" that allow retirement plan distributions to be made over the life expectancies of children or even grandchildren. What is not always well-

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[113] Reg. § 1.401(a)(9)-4(A-4)(c).
[114] See text accompanying footnote 9.
[115] Reg. § 25.2518-2(c)(3).
[116] See Choate, *Life and Death Planning for Retirement Benefits*, 4th edition 2002, at pages 269-70. This argument is based on Letter Ruling 9809059, which cited these as items which were not payable by the trust it approved.
[117] Letter Rulings 200221056, 200548027 and 200548028.
[118] The ideas in this section came from some brainstorming with Paul G. Griesemer, who is in the Employee Benefits practice area of Thompson Coburn LLP. He informed the author of the rule the non-transferable annuity contract distributed from a qualified plan is not taxable until distributions are received form the contract. This section was published on page 43 of the September 2002 issue of *Trusts & Estates* magazine, and the author appreciates input provided by editors Natalie Choate and Rorie Sherman, who are not to be held responsible for any of the content that the reader might not like.

publicized is that many qualified retirement plans adopt stricter rules. Although beneficiaries often want to stretch out distribution to defer income tax, many employers require immediate distribution to avoid administrative burdens.

For distributions on or after January 1, 2007, an employee's beneficiaries may do a "direct rollover" to an "inherited IRA."[119] A "direct rollover" is a distribution directly from the employer's plan into the IRA; a direct rollover not only is required but also avoid the mandatory income tax withholding that may be required of lump sum distributions from qualified plans. An "inherited IRA" is an IRA set up in the decedent's name for the benefit of a beneficiary, distributed over the appropriate life expectancy.

Before January 1, 2007, another possible solution is for a qualified plan to allow a deceased employee's beneficiaries to direct the plan to buy a nontransferable annuity and distribute the annuity to the beneficiaries.[120] Such a distribution would not be immediately taxable.[121] Instead, the beneficiaries would be taxable as they receive distributions under the annuity contract.[122] This section discusses the distribution requirements the new regulations impose on such contracts and the additional requirements that existing regulations impose regarding non-transferability and other features. See Letter Ruling 200244023.

Instead of making RMDs, the Final Regs allow a plan to satisfy the required minimum distribution requirement by the purchase of an annuity contract from an insurance company with

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[119] Code § 402(c)(11), added by the Pension Protection Act of 2006.

[120] Concern has been raised about whether this technique subjects qualified plans to the qualified joint and survivor annuity/qualified pre-retirement survivor annuity requirements of Code § 401(a)(11) (the "QJSA/PSA requirements"). Profit sharing plans, including 401(k) plans, are exempt from these requirements. Code § 401(a)(11)(B)(iii). If a participant elects to have payment in the form of a life annuity, the participant will become subject to the QJSA/PSA requirements. Code § 401(a)(ii)(B)(iii)(II). This technique involves allowing a beneficiary to elect to receive an annuity in lieu of the cash distribution to which the beneficiary is entitled; it does not involve the participant electing payment in the form of a life annuity. Therefore, providing for this technique will not by itself subject a plan or participant to the QJSA/PSA requirements.

[121] Reg. §§ 1.402(a)-1(a)(2)(providing this rule for taxing employees), 1.402(a)(5)(applying Reg. § 1.402(a)-1 to the beneficiary of deceased employee or retired employee).

[122] Reg. § 1.402(a)-1(a)(2) provides that the annuity's "cash surrender value will not be considered income to the employee unless and until the contract is surrendered." That rule applies to the beneficiary of a deceased employee or retired employee under Reg. § 1.402(a)-1(a)(5). Code § 72(a) taxes any amount received as an annuity. The character of taxation of the distribution from the annuity contract is governed by Reg. § 1.402(a)-1(a)(4), which provides that Reg. § 1.72-16(c) governs the taxation of distributions payable by reason of death. Reg. § 1.72-16(c) provides that, unless a benefit payable by reason of death was life insurance who term portion was taxable to the employee annually under Reg. § 1.72-16(b), distribution payable by reason of death are fully taxable.

the employee's individual account.[123] An annuity may be purchased with part or all of the account.[124] Payments under the annuity contract will satisfy the RMD rules for distribution calendar years after the calendar year of the purchase if payments under the annuity contract are made as described in the next paragraph.[125] If such an annuity is purchased after distributions are required to begin, payments under the annuity contract will be treated as distributions from the individual account in determining whether that account satisfies the RMD rules for the calendar year of the purchase. [126]

Regulations under Code § 401(a)(9)[127] under Code § 4974 [128] (the excise tax on failure to take RMDs) require that the annuity contract actually make payments that comply with the RMD rules. If the contract is a life annuity with a term certain, the term certain may not exceed the life expectancy of the designated beneficiary using the beneficiary's age in the year that contains the annuity starting date.[129]

Under existing final regulations, the annuity contract that the plan distributes to the beneficiaries may not be transferable.[130] If the annuity contract is transferable, then the beneficiaries may correct the defect by making the contract nontransferable with 60 days after the plan distributes the contract.[131]

An annuity contract is transferable if the owner (meaning the beneficiaries, since they will own the contract once it is distributed) can transfer any portion of the owner's interest in the certificate or contract to any person other than the issuer.[132] Accordingly, such a contract is transferable if the owner can sell, assign, discount, or pledge as collateral for a loan or as security for the performance of an obligation or for any other purpose the owner's interest in the contract to any person other than the issuer.[133]

Keep in mind that an annuity contract must meet the requirements of this paragraph and the preceding paragraphs in this article. [134] In other words, the annuity contract must satisfy the

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[123] Reg. § 1.401(a)(9)-5(A-1)(e) (first sentence).
[124] Reg. § 1.401(a)(9)-8(A-2)(a)(3).
[125] Reg. § 1.401(a)(9)-5(A-1)(e) (second sentence).
[126] Payments are required to begin on the required beginning date, in the case of distributions commencing before death, or the date determined under Reg. § §1.401(a)(9)-3(A-3), in the case of distributions commencing after death. The date determined under Reg. § §1.401(a)(9)-3(A-3) is December 31 of the calendar year following the year of death, but is deferred in some cases when the spouse is the sole beneficiary.
[127] Reg. § 1.401(a)(9)-6(A-4).
[128] Reg. § 54.4974-2(A-4).
[129] Reg. § 1.401(a)(9)-6(A-3)(b).
[130] Reg. § 1.402(a)-1(a)(2) (last sentence).
[131] *Id.*
[132] Reg. §1.401-9(b)(3).
[133] *Id.*
[134] *Id.*

rules restricting transferability as well as providing annual distributions that satisfy the RMD rules.

Employers should consider authorizing their plans to buy annuities as described above. This would allow their employees to bequeath benefits with maximum tax-deferral and to protect beneficiaries who would face a big tax bite from a plan that requires immediate distribution. While such an option would increase administrative costs upon an employee's death in that an acceptable annuity must be purchased and distributed, the plan would have no further administrative responsibilities once the annuity contract is distributed.

CONCLUSION

The Final Regs greatly simplify rules governing distributions during a retirement plan owner's life. Many taxpayers will be able to take smaller annual distributions than they would under the prior proposed regulations. However, to a large extent, the complexities of using trusts as beneficiaries under the prior proposed regulations and various letter rulings remain, and have even increased, under the Final Regs. The Final Regs challenge practitioners to exercise creativity in taking advantage of their new opportunities while exercising caution in drafting instruments that avoid their traps.

APPENDIX A – TABLE FOR RMDS
While the Owner Is Living

Owner's Age	Distribution Period
70	27.4
71	26.5
72	25.6
73	24.7
74	23.8
75	22.9
76	22.0
77	21.2
78	20.3
79	19.5
80	18.7
81	17.9
82	17.1
83	16.3
84	15.5
85	14.8
86	14.1
87	13.4
88	12.7
89	12.0
90	11.4
91	10.8
92	10.2

Owner's Age	Distribution Period
93	9.6
94	9.1
95	8.6
96	8.1
97	7.6
98	7.1
99	6.7
100	6.3
101	5.9
102	5.5
103	5.2
104	4.9
105	4.5
106	4.2
107	3.9
108	3.7
109	3.4
110	3.1
111	2.9
112	2.6
113	2.4
114	2.1
115 and older	1.9

Appendix A – Table for RMDs

After the Owner's Death [*]

Beneficiary's Age	Distribution Period
0	82.4
1	81.6
2	80.6
3	79.7
4	78.7
5	77.7
6	76.7
7	75.8
8	74.8
9	73.8
10	72.8
11	71.8
12	70.8
13	69.9
14	68.9
15	67.9
16	66.9
17	66.0
18	65.0
19	64.0
20	63.0
21	62.1
22	61.1
23	60.1
24	59.1
25	58.2
26	57.2
27	56.2
28	55.3
29	54.3
30	53.3
31	51.4
32	51.4
33	50.4
34	49.4
35	48.5

Beneficiary's Age	Distribution Period
37	46.5
38	45.6
39	44.6
40	43.6
41	42.7
42	41.7
43	40.7
44	39.8
45	38.8
46	37.9
47	37.0
48	36.0
49	35.1
50	34.2
51	33.3
52	32.3
53	31.4
54	30.5
55	29.6
56	28.7
57	27.9
58	27.0
59	26.1
60	25.2
61	24.4
62	23.5
63	22.7
64	21.8
65	21.0
66	20.2
67	19.4
68	18.6
69	17.8
70	17.0
71	16.3
72	15.5

Beneficiary's Age	Distribution Period
74	14.1
75	13.4
76	12.7
77	12.1
78	11.4
79	10.8
80	10.2
81	9.7
82	9.1
83	8.6
84	8.1
85	7.6
86	7.1
87	6.7
88	6.3
89	5.9
90	5.5
91	5.2
92	4.9
93	4.6
94	4.3
95	4.1
96	3.8
97	3.6
98	3.4
99	3.1
100	2.9
101	2.7
102	2.5
103	2.3
104	2.1
105	1.9
106	1.7
107	1.5
108	1.4
109	1.2

[*] This applies for the year after the owner's death. The resulting period is reduced by one for each subsequent year.

36	47.5	73	14.8	110	1.1
				111+	1.0

APPENDIX B – TYPES OF TRUSTS

	Conduit Trust	Limitation on Beneficiaries
Typical Provisions	"All amounts distributed from [the] account … to the trustee while [the beneficiary] is alive will be paid directly to [the beneficiary] upon receipt by the trustee."[135]	Plan benefits may <u>not</u> be distributed to, or accumulated for the benefit of: (1) any individual older than the measuring beneficiary(ies), or (2) any entity. This applies to current beneficiaries and remainder beneficiaries.[136]
Special Drafting Notes	Trustee is required to withdraw from the plan no less than the RMD.	Cannot use general powers of appointment or name descendants' spouses as a class.
Spousal Distribution Exceptions?	Yes.	No.
Marital Trust	This is ideal if the trust's purpose is merely to prevent the surviving spouse from spending it all at once.	This is not a problem if the only remainder beneficiaries are descendants or trusts for only descendants (see below).
GST-Exempt Trust	A conduit trust is contrary to the goal of accumulating wealth.	This is not a problem if the only beneficiaries are descendants.
Periodic Terminating Nonexempt Trust	A conduit trust works well, but it forces distributions to UTMA accounts.	This is not available, since nonexempt trusts use conditional general powers of appointment.
Lifetime Nonexempt Trust	This is an ideal combination if the trust's purpose is merely to prevent the beneficiary from spending it all at once.	This is not available, since nonexempt trusts use conditional general powers of appointment.

In either case, estate taxes should not be apportioned to plan benefits to the extent that other assets are available to pay taxes.

135 Reg. § 1.401(a)(9)-5(A-7)(c)(3), Example 2.
136 Reg. § 1.401(a)(9)-5(A-7)(c)(3), Example 1(iii)(third sentence).

APPENDIX C – SAMPLE BENEFICIARY DESIGNATION[137]

RETIREMENT ACCOUNT OF [OWNER'S NAME]
ATTACHMENT TO BENEFICIARY DESIGNATION
[BROKERAGE ACCOUNT NUMBER]

Primary Beneficiary.

If I am survived by my spouse, John A. Doe, then my entire account shall be paid to my spouse. However, if and to the extent my spouse (or the personal representative of my spouse's estate) disclaims an interest in the account, then the disclaimed portion of the account shall be paid to the trustee of the Jane B. Doe Unified Credit Trust created upon my death under the provisions of the Jane B. Doe Revocable Trust Agreement dated _____________, [as amended _________________, and] as may be further amended from time to time (the "Revocable Trust Agreement").

Contingent Beneficiary.

If (a) I am not survived by my spouse, or (b) my spouse survives me and dies without designating one or more beneficiaries to receive the full amount of my account, then upon the second to die of my spouse and me, my account, or any portion thereof with respect to which a beneficiary has not been designated, shall be divided into the following shares:

1. One (1) share for each of my children who is then living. For purposes of this instrument my children shall mean [children's names], [and any other child of mine born or legally adopted by me after the date of this instrument.]

2. One (1) share for each of my said children who is not then living but has one or more descendants who is then living.

3. A share established under (2), above, shall be subdivided among the descendants of my deceased child, per stirpes.

The share of each living child, and the subshare of each descendant of a deceased child of mine, shall be paid to the trustee of the Life Trust[138] for such child or descendant under the Revocable Trust Agreement.

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[137] This sample is provided as a starting point. Please construct your own taking into account your client's situation and estate planning goals. Letter Ruling 200537044, which discussed drafting beneficiary designations naming separate trusts created under one trust agreement, provides some guidance, although we cannot rely on it as precedent.

[138] The Life Trust typically includes conduit trust provisions. Instead of making outright distributions of other assets, our forms tend to make beneficiaries trustees and/or give them the power to withdraw all or a potion of a trust at the desired age(s).

Miscellaneous.

1. If my spouse and I shall die simultaneously or under such circumstances that it cannot be determined with reasonable certainty who died first, then it shall be presumed for purposes of this designation that I survived my spouse.

2. The Custodian may conclusively rely upon the certification of the trustee(s) under the Revocable Trust Agreement as to proper payees under the Contingent Beneficiary portion hereof and shall be fully released and discharged from any and all liability for payments in reliance upon such certification.

3. Regardless of who is named as beneficiary above, the trustee(s) under the Revocable Trust Agreement and the personal representative, administrator, or other duly appointed representative of my estate shall be provided with such information regarding my account or the beneficiary(ies) of my account as such person(s) may request.

Date: ____________________________ ____________________________________
Jane B. Doe