The Kitces Report
Advancing knowledge in financial planning...
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Qualifying A Trust As The Designated Beneficiary Of A Stretch IRA

Executive Summary

- Owners of traditional retirement accounts (but not Roth IRAs) are generally subject to required minimum distributions (RMDs) upon reaching age 70 ½. In addition, beneficiaries of retirement accounts after the death of the original owner also face "post-death" RMDs (including for Roth IRAs).

- With post-death RMDs, the exact requirements for how quickly the retirement account must be liquidated after death will vary depending on the nature of the beneficiary. Designated beneficiaries, defined as individuals (living, breath human beings) are subject to one set of rules, while non-designated beneficiaries are subject to a second (less favorable) set of rules.

- Spousal beneficiaries are eligible for the most favorable treatment of rolling the account over into their own names or leaving it in the decedent's name but not beginning RMDs until the original decedent would have reached age 70 ½.

- Non-spouse designated beneficiaries are allowed to stretch the account out over their life expectancies, while non-designated beneficiaries (e.g., non-individuals like corporations, charities, and many types of trusts) receive the least favorable treatment of distributing under the 5-year rule. In either case, if the decedent passed away after his/her required beginning date, the retirement account can be stretched over the decedent's life expectancy (which may only be slightly longer than 5 years at that point!).

About the Author

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- Treasury Regulations *do* allow certain trusts to be treated as designated beneficiaries, which in turn become eligible to stretch out the post-death RMDs based on the life expectancy of the underlying trust beneficiaries. However, to qualify, the trust must meet specific requirements, including that it must be a valid trust under state law, it must be irrevocable (or become irrevocable at the death of the retirement account owner), the beneficiaries must all be identifiable and be designated beneficiaries themselves, and documentation of the trust must be provided to the plan administrator or custodian in a timely manner.

- With multiple beneficiaries, the oldest beneficiary's life expectancy must be used to determine the stretch period. Once a trust qualifies as a designated beneficiary, careful inspection of the trust's underlying beneficiaries is required to determine which ones will be considered to evaluate who is the oldest.

- To simplify the process of evaluating trust beneficiaries, a "conduit trust" that simply passes through to a particular beneficiary all the RMDs received from the IRA can stretch based on the life expectancy of just the one conduit beneficiary, and ignore any other subsequent beneficiaries.

- Any trust that does *not* pass through all RMDs to a current income beneficiary, and instead can accumulate them for subsequent remainder beneficiaries, is treated as an "accumulation trust" and any beneficiary that can potentially receive an accumulated RMD must be considered for determining the stretch. The only beneficiaries that can be ignored are those who would be a mere successor beneficiary to whoever is to receive the last outright distribution from the trust.

- The potential accumulation of RMDs within the trust matters not only for evaluating the list of beneficiaries to find the oldest with the shortest life expectancy for the stretch, but also for income tax purposes. Any RMDs received by the trust but distributed through to the beneficiary will also pass through the taxable income and associated tax consequences to the beneficiary. However, any RMDs accumulated in the trust will remain on the trust's tax return, potentially subject to the unfavorable compressed trust tax brackets.

Introduction

The tax law provides that tax-preferenced retirement accounts, accumulated over an individual's lifetime, must ultimately be liquidated by the account owner's beneficiaries after death of the original owner. However, to partially preserve the favorable treatment – and reduce the "risk" that the account must be liquidated quickly, with potentially unfavorable tax consequences – Congress allows the beneficiary to "stretch" out the post-death distributions of a retirement account over his/her life expectancy.

However, in some cases, a retirement account owner would rather not leave the account to a beneficiary outright, but instead to a trust, whether to limit access to the money for a spendthrift, protect it from future creditors, or shelter it from future estate taxation. Yet in the case of a trust as beneficiary of a retirement account, the situation is more complex. A trust is ultimately "just" an entity defined by a piece of paper, not a living, breathing human being, which means it doesn't necessarily even *have* a life expectancy over which a retirement *could* be stretched.

To resolve the issue, the tax code provides the opportunity to stretch out the distributions of a retirement account payable to a trust by "seeing through" the trust to the underlying beneficiaries, and using their life expectancies instead. However, this "see-through" trust rule has several unique and very specific requirements that must be satisfied to take advantage of the rule.

In this month's newsletter, we look in depth at the issues involved in naming trusts as beneficiaries of retirement accounts, from the requirements for the trust to qualify as a "designated beneficiary" eligible for stretch treatment based on the underlying beneficiaries, to which beneficiaries must be considered for stretch purposes based on whether the trust is treated as a "conduit" or "accumulation" trust, and also the income tax ramifications of choosing to use a situation in such situations. In next month's newsletter, we will continue the discussion with an exploration of the substantive planning issues and opportunities of using a trust as the beneficiary of a retirement account, and how a trust-as-beneficiary-of-an-IRA plays out with most popular types of trusts such as bypass, marital QTIP, spendthrift, or asset protection.

Anatomy Of A Required Minimum Distribution (RMD)

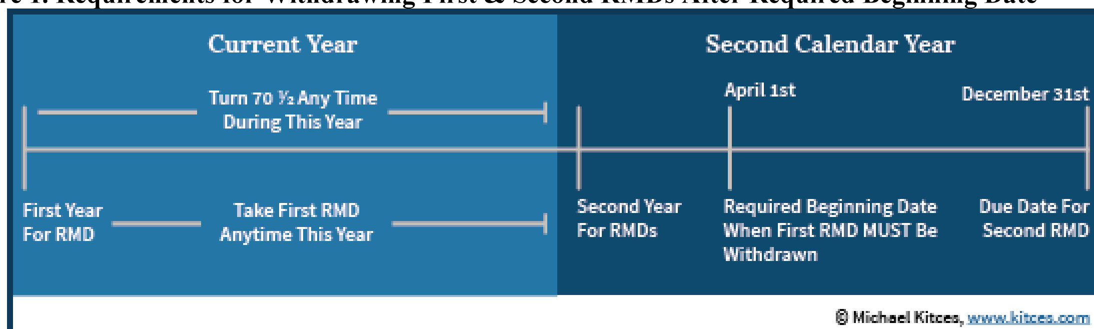
Given that retirement accounts are tax-preferenced – potentially allowing for decades of tax-deferral or tax-free growth – Congress implemented the "Required Minimum Distribution" (RMD) rules, to ensure that assets are eventually forced out of retirement accounts, either for retirees themselves, or their heirs after the death of the original IRA owner.

RMDs For Retirement Account Owners

Under the Internal Revenue Code, owners of traditional (pre-tax) retirement accounts (including employer retirement plans[1] and IRAs[2], but *not* Roth IRAs) are first subject to required minimum distributions for the year in which the account owner reaches age 70 ½. The first RMD is due by his/her "required beginning date", which is defined as April 1 of the year after the individual reaches age 70 ½[3] (or in the case of an employer retirement plan, April 1 of the year after retirement, if later[4], as long as that individual is not a more-than-5% owner of the business[5]). Subsequent RMDs are due for each subsequent calendar year, as shown in Figure 1 below.

After a drastic simplification of the lifetime RMD rules with new Treasury Regulations issued in 2002[6], the current rules stipulate that once an individual reaches the required beginning date, actual RMDs are calculated by dividing the "Applicable Distribution Period" into

Figure 1. Requirements for Withdrawing First & Second RMDs After Required Beginning Date

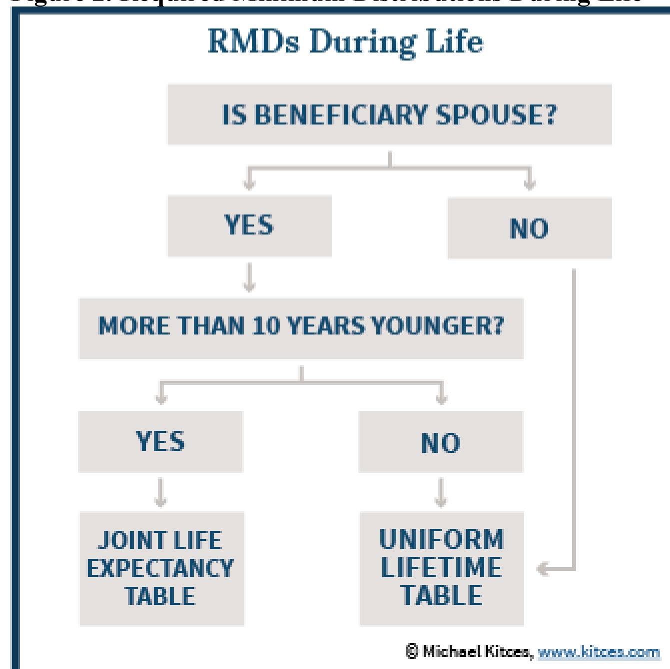


the owner's account balance as of 12/31 of the prior year.

Under the prior rules for retirement accounts, the Applicable Distribution Period was calculated by determining the joint life expectancy of the account owner and (each) beneficiary, such that multiple retirement accounts could each have their own RMD calculations.

Since 2002, however, the current rules simply state that the Applicable Distribution Period is uniformly assumed to be the joint life expectancy of the account owner and a hypothetical beneficiary 10 years younger (regardless of whether the actual age of the beneficiary is more or less than 10 years younger[7]). The age of the account owner for the purpose of these rules is based on the age he/she *will turn on his/her birthday in the current year*[8], and the associated life expectancy factor is found in what is now known as the "Uniform Lifetime Table" in Appendix C of IRS Publication 590. In the case of a spouse as the sole beneficiary of a retirement account, the account owner may use the actual joint life expectancy of himself/herself and the spouse (if more favorable than the Uniform Lifetime Table) to determine the Applicable Distribution Period.[9] In all other situations, though, the Uniform Lifetime Table applies, as shown in Figure 2 below.

Figure 2. Required Minimum Distributions During Life



RMDs For Beneficiaries After The Death Of The Retirement Account Owner

While the rules for determining RMDs during the lifetime of the retirement account owner are fairly straightforward, the rules for required minimum distributions to beneficiaries after the death of the owner are somewhat more complex.

Initially, beneficiaries of retirement accounts are broken into two distinct groups: "designated" beneficiaries, and non-designated beneficiaries. A designated beneficiary is defined as "any *individual* designated as a beneficiary"[10] of the retirement account. While such a definition may appear redundant (a designated beneficiary is a beneficiary who is designated!), the key distinction in qualifying for designated beneficiary status is that the beneficiary must be *an individual* – i.e., a living, breathing human being. Thus, in essence, living persons can all qualify as designated beneficiaries, but non-living entities (e.g., corporations, estates, charities, and many types of trusts) do not.

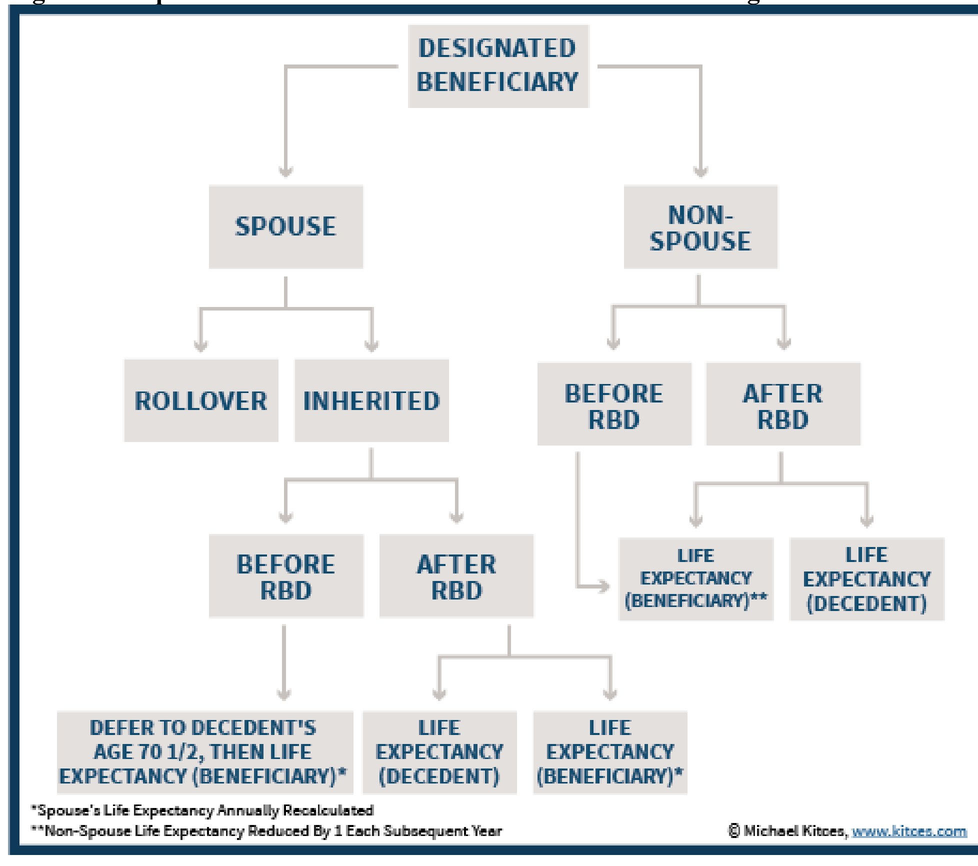
Notably, while Roth IRAs have no required minimum distribution obligations while the account owner is alive, the rules for post-death RMDs apply equally to Roth and traditional retirement accounts. The tax treatment *of* the RMDs will differ – traditional retirement account RMDs will be taxable (except to the extent of non-deductible contributions recovered on a pro-rata basis) while Roth RMDs will generally be tax-free (though technically growth is only a tax-free qualified distribution if the Roth account has aged 5 tax years since the decedent originally established it[11]), but inheritors of both types of accounts must follow the respective rules for designated and non-designated beneficiaries.

Designated Beneficiaries

In the case of a designated beneficiary, the post-death RMD rules further vary depending on whether that designated beneficiary is the spouse of the deceased IRA owner, or is any other (non-spouse) living beneficiary, as shown in Figure 3 (next page).

In the case of a spousal beneficiary, the surviving spouse has the choice of whether to leave the account as an inherited IRA, or roll the funds over into an IRA in his/her own name.[12] If the funds are rolled over, the IRA is (from that point forward)

Figure 3. Required Minimum Distributions After Death For Designated Beneficiaries



simply treated as his/her own individual IRA, with all the normal (living account owner) RMD rules in effect (including potential early withdrawal penalties).[13] If the funds remain as an inherited IRA, the spouse's treatment depends on whether the decedent died before or after his/her required beginning date. If death occurred before the RBD, the spouse may defer post-death RMDs until the year the *original decedent* would have reached age 70 ½, and then must begin distributions based on the *surviving spouse's* single life expectancy based on his/her age in the first year of distribution (and recalculated each year thereafter).[14] If death occurred after the RBD, the spouse must begin post-death RMDs in the year after death, based on either the single life expectancy of the decedent (reduced by 1 each subsequent year) *or* the single life expectancy of the surviving spouse (recalculated each subsequent year), whichever provides the longer stretch.[15]

In the case of a non-spouse designated beneficiary, the post-death RMD rules allow the beneficiary to begin to take post-death RMDs in the year after death, based on the beneficiary's single life expectancy (and reduced by 1 each subsequent year).[16] Alternatively, if death occurred after the original retirement account owner's required beginning date, the beneficiary is permitted to take post-death distributions based on the single life expectancy of the age the decedent would have been (in the year after death) instead, if that produces a longer, more favorable stretch period (e.g., in the case where the decedent was already past age 70 ½ but the beneficiary was/is even older).[17]

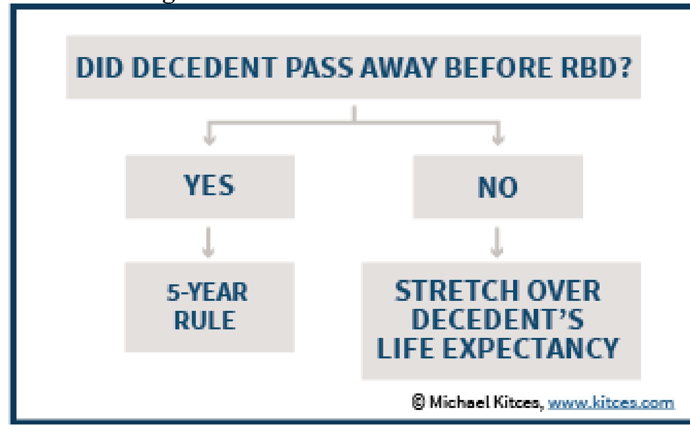
Non-Designated Beneficiaries

In the case of a non-designated beneficiary – such as a corporation, an estate, a charity, or many types of trusts) – the traditional opportunity to stretch over the life expectancy of a beneficiary does not apply, because non-designated beneficiaries are not living, breathing human beings *with* a life expectancy in the first place!

As a result, the options for post-death RMDs for a non-designated beneficiary (shown in Figure 4, top of next page) are simply based on whether the decedent had reached his/her required beginning date at death. If the decedent passed away before the RBD, the (non-designated) beneficiary is subject to the 5-year rule, that the entire account must be liquidated by the end of the 5th year after death.[18] If the decedent passed away after the RBD, the beneficiary *is* eligible to stretch over a single life expectancy based on what the decedent's age would have been in the year of death[19]; of course, since this rule only applies for those account owners who passed away after the RBD, that decedent's-life-expectancy stretch may not be all that much longer than 5 years anyway!

Notably, though, while trusts are generally treated as non-designated beneficiaries – subject to a less favorable stretch treatment due to the lack of any beneficiary with a life expectancy – special rules do exist that potentially allow a trust to be treated as a designated beneficiary, with a stretch permitted by "seeing through" the trust to use the life expectancy of the underlying trust beneficiary, as explained in the next section.

Figure 4. Required Minimum Distributions After Death For Non-Designated Beneficiaries



Multiple Beneficiaries And The Beneficiary Determination Date

In the case of multiple beneficiaries of a retirement account, the general rule is that the beneficiary with the *least favorable* life expectancy will determine the stretch period for the entire account and all beneficiaries. Thus, if there are multiple designated beneficiaries, the oldest beneficiary with the shortest life expectancy must be used to determine the stretch. If there is a combination of designated and non-designated beneficiaries, the non-designated beneficiary treatment will control the outcome of the account.

However, there are two exceptions to this general rule that the least favorable beneficiary controls the outcome of the post-death RMD rules.

The first is that under Treasury Regulation 1.401(a)(9)-4, Q&A-4, the determination of beneficiaries for the purpose of the stretch rules is made not as of the date of death, but as of the "beneficiary determination date" of September 30 in the year *after* the year of death. Any beneficiaries of the account as of the date of death, whose interests are extinguished by the determination date – either by already having received the beneficiary share, or by disclaiming it – are not considered. Thus, for instance, if an account had three beneficiaries, including two children and a charity, and the charity's share was simply paid out between the date of death and September 30 of the following year, then only the remaining beneficiaries – the two children – would have to be considered, effectively avoiding the unfavorable treatment that would attach to having a non-designated-beneficiary charity involved.

The second exception is that under Treasury Regulation 1.401(a)(9)-8, Q&A-2(a)(2), if separate accounts are created for each beneficiary by December 31st of the year after the account owner's death, then the applicable distribution period for each beneficiary's share is calculated separately. As a result, each beneficiary is effectively allowed to take distributions based on his/her own life expectancy, rather than forcing all of the retirement assets to be withdrawn based on the stretch period for the (oldest and) least favorable life expectancy. Thus, for instance, if an account had three beneficiaries, including two children and a charity, and the account was split into three separate accounts for each beneficiary, then each share would be subject to post-death RMDs based on its own respective beneficiary, allowing each child to stretch based on his/her own life expectancy, and forcing only the charity to withdraw under the 5-year rule (which may well be a moot point, as a charity beneficiary is likely to liquidate rather than stretching distributions anyway).

Notably, both the beneficiary determination date, and the account splitting rule, may be applied after death to maximize the potential post-death RMD stretch for each beneficiary, though ultimately the retirement account must still honor whichever beneficiaries were named on the retirement account beneficiary designation form in the first place; in other words, accounts may be split for individual stretches, and some beneficiaries may have their interests paid out earlier (before the determination date), but the funds can still only be paid (or stretched) to those who were named as beneficiaries in the first place!

Qualifying A Trust As A Designated Beneficiary

Although it is sometimes framed as an uncertainty in the tax law, the Treasury Regulations actually do explicitly permit trusts to qualify as designated beneficiaries, as long as they meet certain requirements.[20] The four key requirements are:

1) The trust must be a valid trust under state law

2) The trust must be irrevocable, or by its terms become irrevocable upon the death of the original retirement account owner.

3) The trust's underlying beneficiaries must [all] be identifiable, and be eligible to be designated beneficiaries themselves.

4) A copy of "trust documentation" must be provided to the retirement account custodian/administrator by October 31st of the year following the year of the account owner's death.

These provisions are each examined in further depth below.

The Trust Must Be A Valid Trust

For most, this requirement is rather easy and straightforward – the trust must be valid and legal under state law to count as a designated beneficiary.[21] This means the trust is properly signed and executed as a trust (witnessed, notarized, etc., as required under state law), does not contain any provisions that would invalidate the trust, and is not a handwritten trust (while many states permit handwritten or "holographic" Wills, most do not permit holographic trusts). Presumably, virtually any trust drafted by a competent attorney that was legally signed and executed in the first place will easily meet this requirement.

The Trust Must Be Irrevocable Or Become Irrevocable At Death

In order for a trust to qualify as a designated beneficiary, its terms and provisions must be known and certain at the time the retirement account owner dies and the IRA (or other retirement account) actually becomes payable to the trust. Thus, the trust must be irrevocable in the first place, or must become irrevocable upon the death of the retirement account owner.[22]

This provision can be satisfied with most individual revocable living trusts, which become irrevocable at the death of the grantor (presuming the grantor of the trust and the owner of the retirement account are the same person!). Be cautious, however, in naming a revocable living trust of a *living* grantor – e.g., a spouse's revocable living trust, or even a joint revocable trust (which may not be irrevocable after the first death). On the other hand, the "irrevocable trust" could potentially be a "sub-trust" under an existing revocable living trust, as long as that sub-trust itself was irrevocable and the retirement account explicitly named it in the beneficiary designation (e.g., "100% to the irrevocable subtrust for my children under Article 5, Paragraph 3 of the Smith Family Joint Revocable Living Trust dated 12/4/2010").

Testamentary trusts created under a Will can easily qualify as a trust that becomes irrevocable at death, as the Will itself becomes irrevocable and unchangeable once the individual has passed away. To avoid "accidentally" naming the estate, though, the retirement account beneficiary designation should still clearly articulate the exact testamentary trust that is intended to be the beneficiary (e.g., "100% to the Family Bypass Trust created under Article 4, Paragraph 1 of my Last Will and Testament dated 11/17/2007").

A third option is simply to create a standalone irrevocable trust, solely for the purpose of being the beneficiary of the retirement account in the future. Notably, while creating such a trust would by definition be irrevocable, the beneficiary designation *of* the retirement account can be changed anytime by the account owner as long as he/she is still alive. Thus, an irrevocable trust as beneficiary of the retirement account actually *could* be changed and revoked before death, not by changing the (irrevocable) trust but simply by the beneficiary designation of the retirement account to a new (trust or other) beneficiary, as shown in Figure 5 (top of next page).

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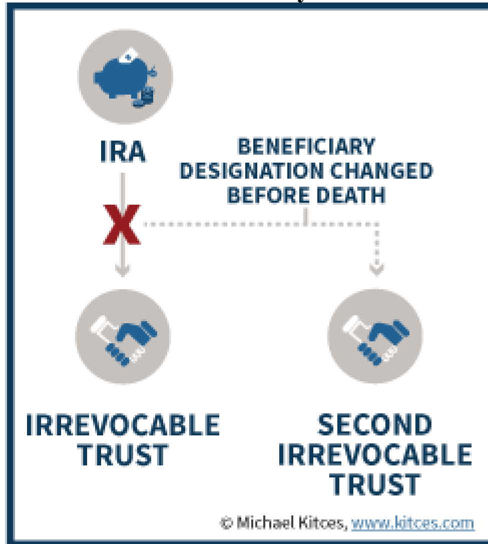
Figure 5. Changing An Irrevocable Trust Beneficiary



Trust Beneficiaries Must Be Identifiable Designated Beneficiaries

In order for a trust to qualify as a designated beneficiary, such that the retirement account can be stretched over the life expectancy of the underlying trust beneficiaries, those underlying beneficiaries must be clearly identifiable under the trust in the first place.[23]

Notably, the rules don't require that each beneficiary be specifically named to qualify as being "identifiable"; naming a "class" of beneficiaries (e.g., "my children" or "my descendants") is valid as well[24], as long as the specific individuals can ultimately be identified as of the beneficiary determination date (September 30th of the year after death[25]) so that life expectancies will be known and the associated stretch period can be determined.

In addition, those underlying beneficiaries must themselves actually *be* eligible for designated beneficiary treatment– in other words, the underlying trust beneficiaries must actually be human beings with a life expectancy over which the retirement account can be stretched! As a result, a trust that has underlying beneficiaries that themselves are non-designated beneficiaries – e.g., a trust that includes a charity as a designated beneficiary – may still fail to satisfy this requirement, even if/though the beneficiaries were clearly identifiable.

Trust Documentation By October 31st Of The Following Year (the "Halloween Rule")

The "Halloween Rule" stipulates that the plan administrator or IRA custodian must be provided a copy of "trust documentation" by October 31st of the year following the year the retirement account owner died.[26]

The documentation requirement can be satisfied by the trustee providing the plan administrator/custodian with either:[27]

a) A copy of the actual trust document named as beneficiary; or,

b) A final list of all beneficiaries (including contingent and remainder beneficiaries and the terms under which they will or may inherit), certifying that the list is correct and complete to the best of the trustee's knowledge, and agree to provide a copy of the actual trust upon demand.

Notably, in some limited situations, clients with extreme privacy concerns (e.g., ultra-high-net-worth or celebrity clients) may be concerned about the requirement to provide a copy of the trust document to the plan administrator/custodian, especially if the trust is not part of an already-public Will and there is concern that the bank may not be able to manage client privacy effectively. In some cases, plan administrators or custodians may be willing to accept a Summary of Trust or an affidavit certifying the accuracy of the beneficiaries without demanding a full copy of the trust, although this can vary from one administrator/custodian to the next. Alternatively, as a prospective estate planning strategy, it may be desirable to use a standalone trust to be the beneficiary of the retirement account, specifically so that if the actual trust document is required by the administrator/custodian, no *other* information from/about the estate and any other trusts will be shared. In other cases, the trustee may even wish to complete a trustee-to-trustee transfer of the inherited IRA to another retirement account custodian, specifically to find one more willing/capable of being respectful of the client's privacy in administering a post-death stretch to the designated beneficiary trust. (Notably, for most clients, normal financial privacy laws will be sufficient protection to provide the administrator/custodian a copy of the trust document if/as needed. Nonetheless, this issue may be a concern for some.)

It is important to bear in mind that while this "Halloween Rule" requirement is a purely administrative documentation requirement, it *is* an explicit requirement in the regulations, and failing to do so in a timely manner can cause an otherwise valid trust to fail to qualify as a designated beneficiary!

The Trust Is A Designated Beneficiary, But What Is The Applicable Distribution Period?

While the aforementioned rules for establishing a trust as a designated beneficiary of a retirement account are relatively straightforward to meet, the greater complexity in using a trust as the beneficiary comes in determining what the applicable distribution period will be for post-death RMDs – in other words, if the Treasury Regulations permit "seeing through" the trust to the underlying beneficiaries to stretch, which of the potentially-multiple-current-and-remainder beneficiaries must be considered to determine whose life expectancy to use?

In the case of a trust that truly just has one single beneficiary, there is clearly only one beneficiary to consider and one life expectancy to apply. However, in most cases, a trust will have multiple beneficiaries involved, as usually a trust (especially in the estate planning context) in some way restricts a beneficiary's immediate access to the trust assets, which means there will usually be at least one subsequent remainder beneficiary involved as well. For instance, a trust established by the decedent that pays income to the surviving spouse as long as he/she is alive, with the remainder subsequently distributed to the children, has multiple beneficiaries – both the surviving spouse, and the children.

A more complex situation arises when a trust is potentially payable to multiple beneficiaries over time. For instance, imagine a (generation-skipping) trust established in the decedent's Will where the trustee is directed to pay income (but not principal) to the spouse as long as he/she is alive, will continue to pay income (but not principal) to the children after the spouse passes away, will only finally distribute the remainder to grandchildren after the death of all the children, and in the event all family members die in a common accident, the trust specifies that the "taker of last resort" is the decedent's alma mater (a charity which would be a non-designated beneficiary).

Trusts As Designated Beneficiaries Of Employer Retirement Plans

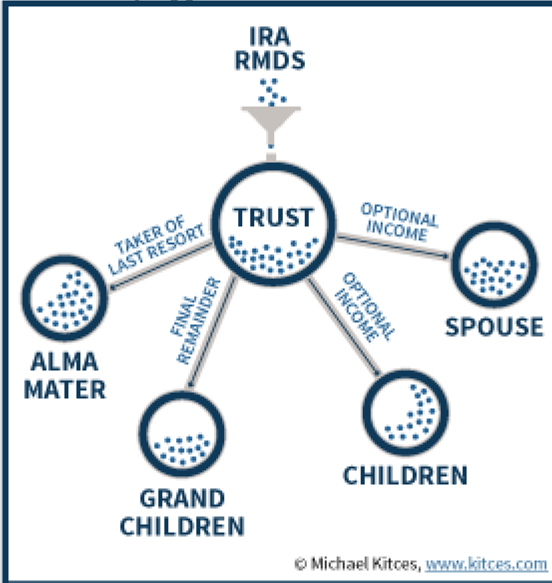
The rules that apply to allow trusts to be designated beneficiaries and qualify for a post-death RMD stretch based on the underlying trust beneficiaries is not unique to IRAs – it is permitted for employer retirement plans as well. However, while trusts may be designated beneficiaries of such accounts, the employer is not required to *offer* a stretch in the first place.

Under Treasury Regulation 1.401(a)(9)-3, Q&A-4, employer retirement plans are *allowed* to adopt a provision that may *require* beneficiaries to withdraw the plan proceeds under the 5-year rule, *even if* there is a designated beneficiary (trust or otherwise). The optional rule was originally created to allow employer retirement plans the choice to *not* offer stretch 401(k) provisions that could become administratively expensive and burdensome in volume (e.g., an employee could leave money to grandchildren and force the plan to administer a stretch for another 50 years even if the employee had only worked there for a year or two in the first place!).

Fortunately, though, the Pension Protection Act of 2006 created IRC Section 402(c)(11), which states that a non-spouse designated beneficiary of an employer retirement plan (including a trust designated beneficiary) may complete a trustee-to-trustee transfer from the inherited employer retirement plan to an inherited IRA – which allows the (trust) designated beneficiary to subsequently do a stretch from the IRA, even if the employer retirement plan would have otherwise required the 5-year rule. Although the provision was originally optional, it was made a requirement to be offered for all designated beneficiaries beginning in 2010 under the Worker, Retiree, and Employer Recovery Act of 2008, which means going forward any trust beneficiary of an employer retirement plan can ensure a stretch by completing such a trustee-to-trustee transfer to an inherited IRA.

Notably, though, the rules do require that such a transfer is completed as a *direct* trustee-to-trustee transfer; if the trust receives a distribution from the employer retirement plan, it *cannot* be rolled over, under IRC Section 408(d)(3)(C).

Figure 6. Potential IRA Beneficiaries In Determining Applicable Distribution Period



Given all these multiple potential beneficiaries (as shown in Figure 6) possibly spanning many decades, which one(s) must be considered for the purpose of a stretch? The spouse? The children? The grandchildren? Will the alma mater charity ruin the stretch for everyone as a non-designated beneficiary?

The general rule for multiple beneficiaries of a trust (still determined as of the beneficiary determination date of September 30th in the year after death) is that, when there are both income and remainder beneficiaries entitled to a share of the decedent's account, that *all* such beneficiaries must be considered for the purposes of determining which is the oldest beneficiary with the shortest life expectancy (or if there is a non-designated beneficiary that might disqualify the stretch altogether).[28] The only beneficiaries who may be excluded are those who are a "mere potential successor" for a prior income or remainder beneficiary.[29] However, in practice with complex trusts that have multiple beneficiaries, it is sometimes difficult to determine who is an income, remainder, or mere potential successor beneficiary. To help apply these rules and determine which beneficiaries to include (or

Are RMDs Considered "Income" For Trust Accounting Purposes?

A taxable distribution from a traditional IRA is clearly treated as "income" for tax purposes. However, when the terms of a trust stipulate that the trustee will pay out "all income" to a beneficiary, "income" is interpreted not based on whether the payments are *taxable*, but whether the dollars are treated as "income" under trust accounting for principal and income.

This distinction is important, because under the most recent version of the Uniform Principal and Income Act (UPIA), *an RMD by default is treated as being 10% income and 90% principal*. Thus, if a $1.1M IRA pays a $30,000 RMD to the trust, and the trust directs the trustee to "pay all income annually to the beneficiary" the trust will only pass through $3,000, not all $30,000!

The reason for this provision is that at the IRA level, the $1.1M account itself constitutes principal, upon which the IRA earns interest and dividends (and capital gains). To the extent that the IRA itself only grew a few percent in the current year, and pays out an RMD from the account, it makes sense that a portion of each distribution will be considered the "gains" on the account for the current year, with the rest allocable to the principal that the IRA already had at the start of the year. (In fact, assuming that 10% of each distribution is income is actually generous, given today's relatively low interest rate and yield environment!)

In the context of a conduit trust, this is important, as it means that even a trust stipulating it will pay "all income annually" to the beneficiary may actually *not* be a conduit trust, because it will only actually pass through 10% of each RMD and accumulate the rest!

Ultimately, though, it is important to verify the treatment of the income/principal allocation for an RMD for the particular state in which the trust is based. Not all states have passed the latest version of the UPIA, some states retain older versions of the UPIA (which had a different treatment for RMDs), and some states operate on their own rules altogether. In addition, many states allow trusts to override the UPIA default and apply their own rules, but only if the state law allows it and the trust actually has provisions to do so (i.e., in a state that permits it, the trust could be written to state that *all* RMDs *will* be treated as "income" for accounting purposes, and then a trust that distributes all income annually really *will* distribute all of every RMD to the beneficiary and be eligible for conduit trust treatment).

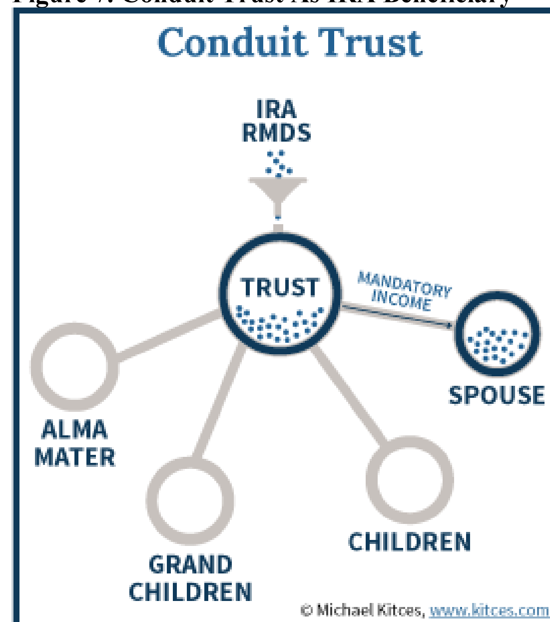
exclude), the Treasury Regulations essentially break trusts into two categories – *conduit*, and *accumulation* trusts – each of which have different rules regarding which beneficiaries must be considered.

Conduit Trusts

Although the label is never explicitly used, the Treasury Regulations effectively define a "conduit" trust as one where all post-death RMDs that are distributed from the IRA to the trust will be passed through to the trust's (income) beneficiary and cannot be accumulated for any other subsequent beneficiary.[30] In such circumstances, the conduit beneficiary is deemed to be the sole beneficiary of the trust's interest in the IRA – after all, if the beneficiary lives long enough, the beneficiary *will* receive the entire IRA – and any subsequent beneficiaries are therefore considered to be "mere potential successors" that do not have to be considered for the purpose of the applicable distribution period.

Thus, when the IRA is payable to a designated beneficiary trust that in turn will make conduit payments to a particular sole beneficiary, that sole beneficiary's life expectancy is the one that will apply for the post-death RMD stretch. All other subsequent/remainder beneficiaries are ignored, as shown in Figure 7.

Figure 7. Conduit Trust As IRA Beneficiary



Notably, this also means that if the beneficiary of the conduit trust is a spouse as the sole beneficiary, the normal spousal-beneficiary-of-inherited-IRA rules will apply, and the trust can actually defer beginning post-death RMDs until the original decedent would have reached age 70 ½, if the decedent had passed away before his/her required beginning date.[31]

Accumulation Trusts

Given that a conduit trust is one where all RMDs will be payable only to the conduit beneficiary and cannot be accumulated for anyone else, an accumulation trust is one where the RMDs *can* be accumulated inside the trust and may ultimately be distributed to some other beneficiary. In essence, this means that any trust which does not specifically meet the requirements for a conduit trust must, by default, be an accumulation trust.

The significance of an accumulation trust is that, because multiple beneficiaries may have a stake in the IRA payable to the trust, then multiple beneficiaries must be considered for the purposes of determining whose life expectancy is the shortest when calculating the applicable distribution period for the stretch. As noted earlier, both current income and contingent/remainder beneficiaries must be considered, and only those who are a "mere potential successor" to a vested interest can be ignored.

In practice, the effective result is that with an accumulation trust every beneficiary that is eligible to receive current or future funds under the trust must be considered *until* reaching the beneficiary that will receive a full, outright distribution. Once that beneficiary is reached, the entire interest of the IRA is presumed to have been paid, such that any subsequent beneficiary from that point onward is only a potential successor *to* a beneficiary that actually has a vested interest in the account.

Thus, in the context of the earlier testamentary family generation-skipping-trust example, where the trustee would make distributions of income (but not principal) to the surviving spouse, then subsequent income (but not principal) distributions to the children, then a final distribution of the remaining trust assets to the grandchildren, with the decedent's alma as the "taker of last resort" in lieu of the grandchildren if there are none surviving… given that this is an accumulation trust, the spouse and children would be income beneficiaries (and must be included), the grandchildren would be the remainder beneficiary (and must be included), but the decedent's alma mater would merely be a potential successor for the grandchildren (who were already due

to receive the remainder of the trust's interest in the IRA) and thus would not need to be included, as shown in Figure 8.

In the case of accumulation trusts, the distinction between whether a beneficiary is an income/remainder beneficiary versus just a successor is crucial, as it can have a significant impact not only on the applicable distribution period (e.g., if a particular income or remainder beneficiary is much older than the rest, everyone may be subjected to a shorter stretch period), but may trigger the inclusion of a non-designated beneficiary (e.g., a charity that is a beneficiary of the trust) that causes the entire trust to fail to qualify as a designated beneficiary!

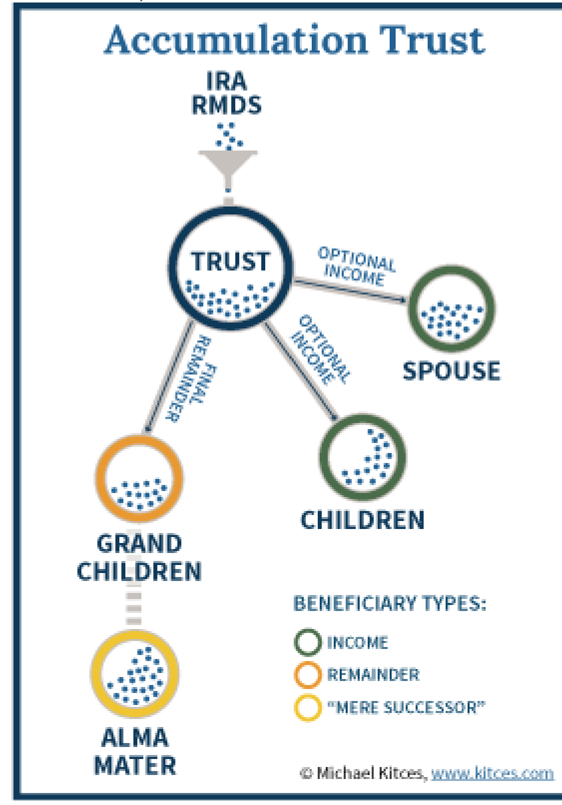
Separate Account Treatment For Multiple Beneficiaries Of Accumulation Trusts

In a "normal" situation with multiple beneficiaries, the separate account treatment is available that allows each beneficiary to stretch based on his/her own life expectancy (and *only* his/her own life expectancy) as long as the inherited IRA is split into separate inherited IRAs for each beneficiary.

However, this separate account treatment is not available for a trust with multiple beneficiaries. From a practical perspective, it would often not be feasible, simply because the interests cannot be cleanly split anyway; for instance, a trust that names mother and daughter as 50/50 beneficiaries might be capable of a split, but a trust that names mother as current income beneficiary and daughter as remainder beneficiary would have no practical way of splitting into separate inherited accounts (since the daughter's exact share won't be known until the future when it's clear how much the mother did or did not withdraw!).

Yet even in the situation that an IRA is left entirely to a trust that names the mother and daughter as 50/50 beneficiaries, the separate account treatment is still not available, simply because the Treasury Regulations outright forbid the use of separate account treatment for the underlying beneficiaries of a single trust.[32] Simply put, as long as the beneficiary designation form of the retirement account itself states "100% to the trust" there is only one beneficiary for the purposes of separate account treatment, even if there are multiple underlying beneficiaries used just to determine the applicable distribution period for stretching the retirement account *to* that sole trust.

Figure 8. Accumulation Trust: Income, Remainder, & Mere Successor Beneficiaries



Out and About

- Michael will be speaking for the AICPA Personal Financial Planning Conference on January 19th in Las Vegas regarding "Generating Tax Alpha with Effective Asset Location"

- Michael will be presenting on "Cutting Edge Tax Planning Developments & Opportunities" at FPA Central Florida on January 26th

- Michael will also be presenting on "Applying Behavioral Finance in your Practice" at FPA Tampa Bay on February 24th

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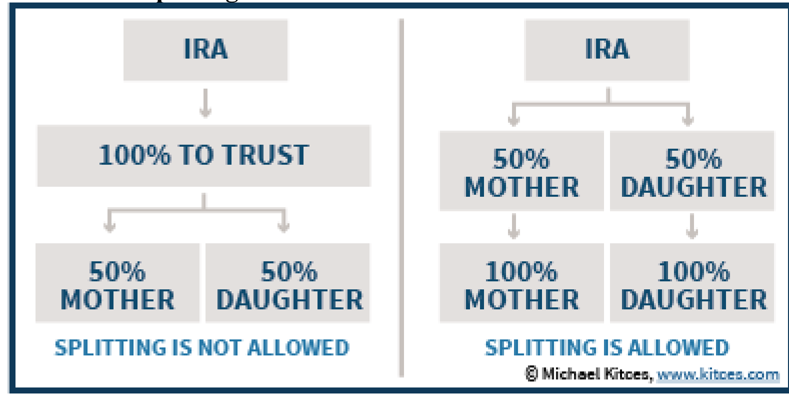
Notably, though, this doesn't mean that a retirement account couldn't be eligible for separate account treatment if it was payable *to multiple trusts* in the first place.

Figure 9. Splitting Trust Beneficiaries Versus Not Splitting Beneficiaries Of A Trust



For instance, if the beneficiary designation form of the retirement account indicated that it was payable 50% to a trust for the beneficiary of the mother, and 50% to a trust for the benefit of the daughter, then the inherited account could be split into separate accounts, one for each trust, and each trust would take post-death RMDs based on the beneficiaries of (just) that trust. The key is the distinction, as shown in Figure 9, between having *multiple trust beneficiaries of the retirement account* (splitting allowed), versus having a sole trust as the beneficiary that has *multiple underlying beneficiaries* (splitting not allowed).

On the other hand, it is also worth noting that if the underlying trusts were not conduit trusts and instead were accumulation trusts where both are a beneficiary of each trust (e.g., where the mother's trust pays income to the mother at the trustee's discretion with the unused remainder to the daughter, and vice versa for the daughter's trust), then *even with* separate account treatment, both trusts would be subject to the same post-death RMD stretch period because the oldest beneficiary (amongst income or remainder beneficiaries) will be the same in both (the mother, who is the income beneficiary of one trust, and the remainder beneficiary of the other).

Income Tax Treatment Of Trusts As Beneficiaries Of Retirement Accounts

An important consideration to the impact of naming a trust as the beneficiary of a retirement account is the income tax treatment of the IRA (or other retirement account) distributions.

As is usual for retirement accounts, distributions from a traditional IRA will be taxable (and any non-deductible contributions are recovered tax-free on a pro-rata basis), while any (qualified) distributions from a Roth will be tax-free. The question arises, however, as to *who* has the tax obligation (in the case of taxable IRA distributions) – the trust, or the underlying trust beneficiaries?

The general rule for the taxation of trusts is that income paid to a trust is taxable income to the trust. This is usually quite *unfavorable* treatment, as the tax bracket thresholds for trusts are significantly more compressed than for individuals (as shown in Figure 10, in 2015 it will take only $12,300 of taxable income to reach the 39.6% tax bracket, whereas the threshold for individuals is $413,201 and for married couples it's $464,850!). This is also the threshold for the new 3.8% Medicare surtax on net investment income (which does not apply to IRA distributions, but may be triggered on other investment income *because* the IRA distribution drove

Figure 10. 2015 Tax Brackets For Individuals, Couples, & Trusts

TAX BRACKET	INDIVIDUAL	MARRIED FILING JOINTLY	TRUSTS
10%	0-$9,225	0-$18,450	N/A
15%	$9,226-$37,450	$18,451-$74,900	0-$2,500
25%	$37,451-$90,750	$74,901-$151,200	$2,501-$5,900
28%	$90,751-$189,300	$151,201-$230,450	$5,901-$9,050
33%	$189,301-$411,500	$230,451-$411,500	$9,051-$12,300
35%	$411,501-$413, 200	$411,501-$464,850	N/A
39.6%	$413,201+	$464,850+	$12,301+

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the trust's income over the threshold). And trusts are generally more limited in deductions, are not eligible for the standard deductions, and receive a much smaller exemption amount than what is available as a personal exemption to individuals.

However, ultimately a trust is only liable for taxes on income paid to the trust if the trust *retains* the income. If, instead, the trust distributes (i.e., passes through) the income to the underlying trust beneficiaries in the same tax year, the trust receives a *distributed income deduction* and the beneficiary instead reports the distributed net income (DNI) on his/her own tax return for the year (the income is reported from the trust *to* the beneficiary on a Form K-1). Thus, for instance, if $50,000 of IRA distributions are paid to a trust, and all $50,000 is passed through to the beneficiary, the trust has $50,000 of income offset by a $50,000 distributed income deduction, the beneficiary will receive a Form K-1 reporting $50,000 of DNI, and the beneficiary will report the $50,000 of ordinary income on his/her own individual tax return, subject to his/her own tax brackets and eligible to be offset by his/her own tax deductions and credits. *(Michael's Note: In a trust that has multiple types of income, the calculation of DNI is somewhat more complex, as it may need to allocate amongst ordinary income from IRAs, other interest and dividend income, capital gains, and tax-exempt income; nonetheless, conceptually the rules remain the same, that income retained in the trust is taxable to the trust, and income distributed to the beneficiary is deducted from the trust and taxable to the beneficiary instead.)*

In practice, this tax treatment for IRA distributions to trusts means the ultimate tax consequences will vary depending on the exact terms of the trust, and potentially the subsequent decisions of the trustee, as shown in Figure 11. After all, a conduit trust may pass through all required minimum distributions annually to the beneficiary – and therefore, the tax consequences associated with those RMDs – but that depends on the terms of the trust. If, instead, the trust is an accumulation trust, whether some, all, or none of the IRA distributions paid to the trust are passed through to the trustee may depend entirely upon the discretion of the trustee; for instance, if distributions are made at the trustee's discretion for the beneficiary's health, education, maintenance, and support, the tax consequences of each IRA distribution to the trust could even vary from year to year depending on whether, in that particular year, the funds were distributed through or not. In some situations, the trustee may even have to balance the unfavorable tax consequences of retaining funds in the trust to satisfy the trust's purpose, versus the often-more-favorable tax treatment of distributing the funds to the beneficiary (but only if the distribution is consistent with and allowable under the terms of the trust!).

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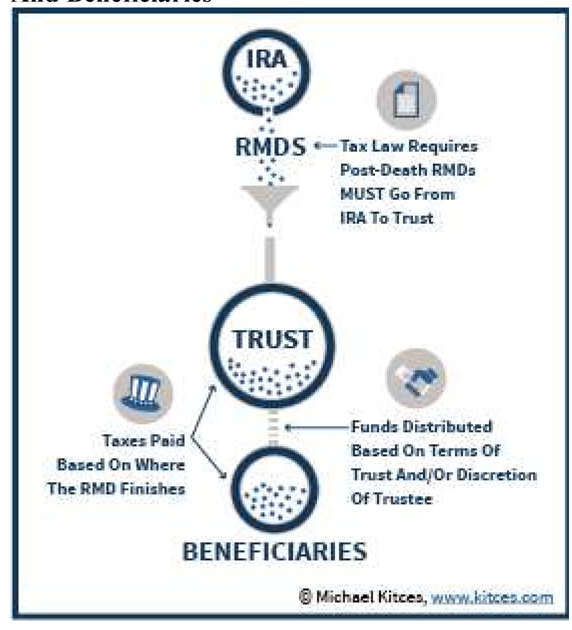
In addition, as noted earlier, the tax consequences of RMDs and whether they are passed through the trust at all may depend on the state's (or trust's) own definition of "income" for accounting purposes (*see breakout box on page XX entitled "Are RMDs Considered "Income" For Trust Accounting Purposes?"*). To the extent an RMD is treated as 10% income and 90% principal for accounting purposes, a trust that requires the trustee to pay out "all income annually" to a beneficiary may nonetheless end out retaining the majority of each year's RMD for tax purposes, and as a result only a portion of each RMD's taxable income will be passed through to the beneficiary's tax return, with the remainder still reported on the trust's own tax return.

Figure 11. Taxation Of IRA RMDs To Trust And Beneficiaries



Conclusion

In the end, the reality is that the requirements for qualifying a trust as the designated beneficiary of a retirement account are actually rather straightforward to satisfy. And once satisfied, the retirement account can be stretched based on the life expectancy of the underlying (oldest) beneficiary of the trust.

Instead, the complication arises in trying to determine exactly which beneficiaries are and are not included in determining who is the oldest beneficiary *for* that stretch, and also in ensuring that the only underlying beneficiaries included are themselves all designated beneficiaries. And while the simplest approach is simply to conduit each RMD every year through to a single beneficiary – and focus on that individual for stretch purposes – in reality most trusts end out at least potentially accumulating RMDs over time, and therefore accumulate beneficiaries as well.

In addition, the complication of whether RMDs are accumulated or distributed affects not only the determination of which beneficiaries are included for stretch purposes, but also the income tax treatment of the IRA distributions as they pass out from the IRA to the trust (and/or whether the income tax consequences also pass through the trust to the underlying beneficiary).

In next month's issue, we'll continue the exploration of using a trust as the beneficiary of a retirement account, with a particular focus on some of the planning strategies involved in using trusts as beneficiaries of retirement accounts, why and when it can be effective to do so, and how the rules overlap with the various types of trusts already commonly used for estate planning in today's environment!

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[1] IRC Section 1.401(a)(9)
[2] IRC Section 408(a)(6)
[3] IRC Section 401(a)(9)(C)
[4] IRC Section 401(a)(9)(C)(i)(II)
[5] IRC Section 401(a)(9)(C)(ii)(I)
[6] T.D. 8987, Final 1.401(a)(9) Treasury Regulations issued 04/16/2002
[7] Treasury Regulation 1.401(a)(9)-5, Q&A-4
[8] Treasury Regulation 1.401(a)(9)-5, Q&A-4(a)
[9] Treasury Regulation 1.401(a)(9)-5, Q&A-4(b)
[10] IRC Section 401(a)(9)(E)
[11] IRC Section 408A(d)(2)(B)
[12] IRC Section 401(a)(9)(B)(iv)
[13] IRC Section 401(a)(9)(B)(iv)(II)
[14] IRC Section 401(a)(9)(B)(iv)(I), Treasury Regulation 1.401(a)(9)-5, Q&A-5(c)(2)
[15] Treasury Regulation 1.401(a)(9)-5, Q&A-5(a)(1)
[16] IRC Section 401(a)(9)(B)(iii), Treasury Regulation 1.401(a)(9)-5, Q&A-5(c)(1)
[17] Treasury Regulation 1.401(a)(9)-5, Q&A-5(a)(1)
[18] IRC Section 401(a)(9)(B)(ii)
[19] Treasury Regulation 1.401(a)(9)-5, Q&A-5(a)(2)
[20] Treasury Regulation 1.401(a)(9)-4, Q&A-5
[21] Treasury Regulation 1.401(a)(9)-4, Q&A-5(b)(1)
[22] Treasury Regulation 1.401(a)(9)-4, Q&A-5(b)(2)
[23] Treasury Regulation 1.401(a)(9)-4, Q&A-5(b)(3)
[24] Treasury Regulation 1.401(a)(9)-4, Q&A-1
[25] Treasury Regulation 1.401(a)(9)-4, Q&A-4
[26] Treasury Regulation 1.401(a)(9)-4, Q&A-5(b)(4)
[27] Treasury Regulation 1.401(a)(9)-4, Q&A-6(b)
[28] Treasury Regulation 1.401(a)(9)-5, Q&A-7(a) and (b)
[29] Treasury Regulation 1.401(a)(9)-5, Q&A-7(c)(1)
[30] Treasury Regulation 1.401(a)(9)-5, Q&A-7(c)(3), Ex. 2(ii)
[31] Treasury Regulation 1.401(a)(9)-5, Q&A-7(c)(3), Ex. 2(ii)
[32] Treasury Regulation 1.401(a)(9)-4, Q&A-5(c)

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