

ESTATE PLANNING: SHOULD A TRUST BE THE BENEFICIARY OF YOUR IRA?

By Clark M. Blackman II and Karen S. Gerstner

Until recently, conflicting tax laws, and a lack of IRS guidance made it difficult to name trusts as beneficiaries of retirement plan assets. However, newer rules and regulations have made the waters safer for those who wish to avail themselves of the tax and estate planning benefits certain trusts can offer.

It is common practice to include testamentary trusts in estate planning documents—and with good reason. They can provide significant tax and non-tax benefits in your estate plan at a moderate cost.

Testamentary trusts are trusts that, although currently documented in your will or “living trust,” come into existence at your death. Until that time, these trusts may be modified or revoked, do not contain any assets, and are not subject to active administration by the trustee. However, at death, assets earmarked for these trusts are transferred to them, the trusts become irrevocable, and the trustee assumes responsibility for prudent management of the trust and its assets.

Because these trusts offer tax and other estate planning advantages (such as creditor protection and ultimate control), it can be beneficial for some individuals to provide that all or a portion of their retirement plan assets (both individual retirement account (IRA) assets and tax-qualified retirement plan assets) pass to a testamentary trust upon their death. To do this, the trust is named as the beneficiary of the retirement plan or IRA. In practice, however, this is not as simple as it sounds.

Until recently, conflicting tax laws, along with a lack of IRS and judicial guidance, made it difficult to name trusts as beneficiaries of retirement plan assets with any assurance that the outcome would be as desired. However, newer rules and regulations have made the waters safer for those who wish to avail themselves of the full benefits of naming a trust as the beneficiary of their retirement assets (although there are still a few unanswered questions).

This article highlights some of the issues involved in naming a trust as the beneficiary of your retirement plan.

But first, let’s review some of the advantages provided by various types of testamentary trusts.

TRUST ADVANTAGES

One commonly used trust is the “credit shelter” trust. It is also called a “bypass” or “family” trust, or it may be referred to as one of the “A/B” trusts. It is created to allow a couple to take advantage of the estate tax credit. Currently, this credit offsets \$345,800 of estate tax, which is levied on the first \$1 million of your taxable estate. However, the amount of your estate that can receive a credit is scheduled to increase over the next seven years—to \$1.5 million in 2004, \$2 million in 2006, then \$3.5 million in 2009—and then, following a year of no estate tax in 2010, it will drop back to the \$1 million level in 2011 and, presumably, remain at that level for years beyond 2011, unless, of course, all of this is changed by Congress.

The credit shelter trust enables the first spouse to die to take advantage of his or her estate tax exemption amount (which would be wasted if left outright to the surviving spouse), while still providing funds that can be used

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by the surviving spouse during his or her lifetime. In addition, by using the credit shelter trust, the assets remaining in the trust on the surviving spouse's death will pass free of estate tax to heirs selected by the first spouse.

A credit shelter trust provides tax savings if your taxable estate, combined with your spouse's taxable estate, currently exceeds \$1 million—although this amount will change in later years as mentioned above. Remember, your estate includes the proceeds of life insurance policies that you own or control in any way, IRAs and qualified plan assets, homes and other real estate, stocks, bonds, mutual funds, bank accounts and other investments, etc. If both spouses own assets equal to the current estate tax exemption amount, the difference in estate tax on the second spouse's death between not using and using the credit shelter trust (assuming no change in the value of the assets between the two deaths and no change in the estate tax exemption or rates) would be approximately \$345,000.

In addition, the credit shelter trust allows you to maintain control over the final disposition of your assets—if, for instance, you want to provide lifetime benefits to your spouse, but also want the amount remaining on your spouse's death to pass to your children, and not to your spouse's new spouse or children. It may even be considered for that purpose alone. Further, the credit shelter trust can be structured so that its assets are protected from claims made by creditors against any of the trust beneficiaries. This feature is sometimes known as the “spendthrift trust” provision.

Another commonly used testamentary trust is the “QTIP” trust, or qualified terminable interest property trust. This trust allows you to provide assets to support your surviving spouse during his or her life, while maintaining the right to designate the final beneficiaries of the assets in the trust when your

spouse dies. Normally, a “terminable interest” (an interest in property that does not fully pass to your spouse), would not qualify for the unlimited estate tax marital deduction.

If a QTIP trust is structured properly, however, the first spouse to die can have confidence that his or her selected beneficiaries will receive the remainder of the assets not needed by the surviving spouse during his or her lifetime, while avoiding the payment of estate taxes on the QTIP trust assets at the first spouse's death. Remember that estate taxes are not fully eliminated on the QTIP trust assets, however, because the assets remaining in the QTIP trust are subject to estate tax on the surviving spouse's death. Couples where each spouse owns assets valued at more than \$1 million frequently include a QTIP trust in addition to the credit shelter trust as part of their estate plan. This trust is the second trust referred to as part of the “A/B” trust plan.

DISTRIBUTION CONCERNS

An individual's interest in a qualified retirement plan or IRA is an asset of that person's estate for federal estate tax purposes. In addition, a distribution from a retirement plan will usually be taxed to the recipient as ordinary income under the income tax rules. Thus, retirement plan assets are subject to both estate tax and income tax. Because most people want to reduce or eliminate as many taxes as possible, both for themselves and the beneficiaries of their estate, and because the estate tax rules and income tax rules are separate and not necessarily consistent, achieving this goal with retirement plan assets can be very difficult.

People name testamentary trusts as beneficiaries of their retirement plan assets for numerous estate planning reasons, including:

- Eliminating or deferring estate taxes,
- Controlling the ultimate disposi-

tion of assets,

- Providing creditor protection to beneficiaries, and
- Insuring proper management of assets, etc.

However, they do not want their heirs to suffer adverse income tax consequences merely because they are naming a trust as the beneficiary.

Why would it be disadvantageous to name a trust as a retirement plan beneficiary?

The most favorable income tax results occur when a beneficiary can keep the maximum amount possible in an IRA or qualified plan, deferring income taxes until distribution from the plan occurs. In general, spousal beneficiaries have the most favorable distribution rules. But even naming one or more non-spouse individuals directly (assuming they are adults) will ensure a more favorable income tax result if the beneficiaries limit themselves to the minimum distribution amounts when plan assets are received.

Less favorable distribution rules apply to named beneficiaries that are not human beings—for instance, the beneficiary is an estate, charity, trust or other “entity.” The only entity that can be ignored—if structured properly—is a trust.

As the rest of this article will show, however, qualifying a trust for the more favorable “life expectancy” distribution period is not easy.

QUALIFYING A TRUST

The final regulations relating to distributions from retirement plans, released in April 2002, simplify many of the minimum distribution rules. The new rules even provide examples of two types of trusts that will qualify for favorable life expectancy payout. However, the new rules do not provide enough guidance regarding the numerous types of trusts and trust provisions used in estate planning.

If a trust is named as the beneficiary of a participant's plan assets,

and if the trust does not qualify for “designated beneficiary treatment,” the result is an acceleration of the income tax payable on the plan assets passing to the trust. This is due to the rule that only human beings can be “designated beneficiaries” for purposes of the minimum distribution rules and for utilizing the more favorable distribution period based on a human being’s life expectancy.

To minimize acceleration of tax when a trust is named as the beneficiary of plan assets, the trust must qualify for “look through” treatment, so that it will be ignored as an entity. Thus, whether the named “beneficiary” of the participant’s plan assets is a credit shelter trust, a QTIP trust, or some other type of trust, the following four requirements must be met to qualify for this favorable treatment:

- The trust must be a legally enforceable trust under state law (although it is not necessary to “fund” the trust until after the trust creator’s death);
- The IRA custodian/trustee (or qualified plan administrator) must be provided with a copy of the trust instrument by the relevant due date;
- The trust must be irrevocable or become irrevocable upon the death of the plan participant; and
- All trust beneficiaries who could enjoy the benefits of the retirement plan assets must be clearly identifiable from the trust instrument.

It is the fourth requirement that is so problematic. All trusts, by definition, have multiple beneficiaries (at least one current beneficiary and one future beneficiary—a remainder beneficiary). Thus, a detailed analysis must be done to determine which of the trust’s beneficiaries could end up receiving some of the plan assets. This analysis is necessary because of the rules that only human beings can be “designated beneficiaries” and that the oldest trust beneficiary’s life expectancy will be used to deter-

mine the minimum required distributions to the trust following the plan participant’s death.

TWO TRUSTS TO CONSIDER

There are two kinds of trusts that greatly simplify the analysis of the fourth trust requirement: “conduit” trusts and “grantor” trusts.

A conduit trust is one that requires all amounts received by the trust from the retirement plan to be paid out to the current beneficiary of the trust at least annually. In essence, the distribution from the plan merely flows through the trust to the beneficiary. In such a case, the beneficiary entitled to receive the plan assets from the conduit trust is deemed to be the sole beneficiary under the fourth prong of the test—and all other trust beneficiaries (such as the remainder beneficiaries who receive what is left when the current beneficiary dies) can be ignored.

The conduit trust is not a typical trust used in estate planning prior to now. Obviously, if the only asset “belonging to” the trust is the deceased participant’s interest in his retirement plan, and if the current beneficiary lives long enough, there will be very little (if anything) left in the plan to pass on to the remainder beneficiaries at the death of the current beneficiary. This outcome makes the conduit trust less attractive than other types of testamentary trusts used in estate planning. However, it is a very useful trust as an alternative to leaving plan assets outright. Here, the participant allows the beneficiary to receive only the amount of the minimum required distribution from his plan each year after his death, and by naming an independent trustee ensures that result.

The other trust that is simple to analyze in terms of the trust rules is a “grantor” trust. A grantor trust in this context is one over which the current beneficiary is given an unlimited withdrawal right over the trust assets. While grantor trusts are not specifically sanctioned in the

final regulations, numerous IRS rulings predating the final regulations indicate that a grantor trust will be basically disregarded as an entity. This makes sense—if the current beneficiary of the trust has the power to withdraw all of the trust assets, even if he or she does not in fact do so, possessing that power is sufficient to ignore the trust and all of its other beneficiaries and treat the current beneficiary in the same manner as a direct beneficiary.

The most common situation involving a grantor trust in this context is when a husband and wife living in a community property state have created a joint revocable trust (living trust) and have named the trust as the beneficiary of their retirement plan assets. Upon the first spouse’s death, when the deceased spouse’s IRA passes to the trust, usually the community interest of the surviving spouse in the IRA is directed into the “survivor’s trust.” The surviving spouse would typically have the right to withdraw all of the assets in the survivor’s trust during her lifetime. Thus, as to the portion of the IRA passing to that type of grantor trust, the surviving spouse is basically the direct (and only) beneficiary.

OTHER TRUSTS

In analyzing all other trusts to determine compliance with the fourth trust requirement and to further determine which beneficiary of the trust will be treated as the “designated beneficiary” (i.e., the beneficiary whose measuring life is used to calculate minimum required distributions to the trust), the question must be asked, “If the current beneficiary dies, which other trust beneficiaries could receive any of the deceased participant’s plan benefits that have already been paid to the trust, prior to the death of that beneficiary, but not yet distributed?” Thus, these accumulated distributions may actually end up passing to the remainder beneficiaries of the trust.

To understand how and why this happens, state laws governing income and principal allocation rules must be considered. Each state has different standards so it is important that your attorney understands the impact of these rules.

Periodic payments from retirement plans being made over the life expectancy of an individual are in the nature of an annuity. Thus, at some point, the “principal” (initial investment/contribution) is being returned to the “investor” (or his/her beneficiary). Of course, the amount invested in the plan is usually earning income as well, so that a distribution from the plan may represent that year’s earnings only. Many states have artificial percentages that are applied to a distribution to determine the portion to be treated as trust “income.”

State principal and income allocation rules may not require the trustee to track actual income inside the retirement plan, but such a calculation is necessary in the case of plan benefits passing to a QTIP trust. This is because federal estate tax rules require that the surviving spouse, who is the sole current beneficiary of the QTIP trust, receive all “income” from the trust, at least annually (including all income from any retirement plan passing to the trust). Thus, the income portion of the distribution that comes out of the plan must flow through the trust directly to the spouse.

If the minimum required distribution is larger than the earnings achieved by the plan assets that year, then the excess amount may be treated as principal for trust accounting purposes and not distributed. The QTIP trust is usually drafted so that receipts of principal either may or must be retained by the trustee for future distribution to the specified beneficiaries—either to the surviving spouse, if necessary for certain defined purposes (such as health and support), or to the remainder beneficiaries of the trust on the spouse’s death.

Now, let’s turn to the credit shelter trust. With a typical credit shelter trust, frequently the surviving spouse is not the sole current beneficiary although he or she may be the primary beneficiary. In addition, the trustee usually has discretion in determining whether both income and principal should be distributed out of the trust to any of the beneficiaries. Thus, in both of the situations discussed above, since all or a portion of the distribution coming out of the plan may end up with beneficiaries other than the surviving spouse, it cannot be said that the surviving spouse is the sole beneficiary under the trust regulations.

So, who are the other beneficiaries who may receive a share of the plan assets distributed to the trust?

Clearly, the immediate remainder beneficiaries of the trust must also be taken into account in the case of all trusts that could accumulate distributed plan benefits during the term of the trust. This is not necessarily bad, however, because the remainder beneficiaries are often the deceased participant’s children. Assuming that the surviving spouse is the oldest out of all of the “countable” beneficiaries of the trust, if the more remote remainder beneficiaries of the trust can be ignored (either because their interests are tenuous or because they are all clearly younger than the spouse as well), then the fourth trust requirement should be met, and the spouse should be treated as the designated beneficiary for determining the minimum required distributions payable to the trust each year.

The biggest question in analyzing each trust, in terms of the fourth requirement, is how far down the line must you go before you can stop taking into account all of the beneficiaries of the trust who could receive any of the participant’s plan benefits. In addition, if there are beneficiaries who could be added as trust beneficiaries through the actions of one of the current beneficiaries (such as potential beneficia-

ries pursuant to a “power of appointment”), then the interests of those additional beneficiaries in the plan assets must be analyzed as well to determine if any “non-human beings” are potential beneficiaries and whether any of these beneficiaries are older than the intended designated beneficiary.

POWERS OF APPOINTMENT

A general power of appointment will always disqualify the trust for favorable treatment because the recipients of the power are completely unidentifiable “up front” (a general power of appointment is the right of the beneficiary to transfer the remaining interest to anyone he or she wants).

A broad, nongeneral power of appointment will taint the trust as well. Testamentary “special” or “limited” powers of appointment are frequently given to surviving spouses. The beneficiaries of a power of appointment must also be taken into account in evaluating the fourth trust requirement (unless the trust is a conduit trust or grantor trust). If the group of possible appointees includes “charities” or “heirs,” then the trust will not qualify for designated beneficiary treatment.

One seemingly innocuous group frequently included in a special or limited power of appointment is “spouses of descendants.” While in most (but not all) cases a participant’s descendants will all be younger than his or her surviving spouse, spouses of descendants could be any age. Since it is unknown “up front” whether the participant’s child will marry someone older than the participant’s surviving spouse, this general type of provision also fails the test. Of course, an attorney knowledgeable regarding all of these rules should be able to draft a trust that includes definitions or other provisions clearly eliminating “problematic” beneficiaries from receiving retirement plan distributions.

DISTRIBUTION PERIODS

If the four trust rules are not met by a trust named as the participant's beneficiary, the trust will still receive the plan benefits. However, the trust will receive them based on a less favorable payout schedule than would be available if the trust had been able to qualify for "designated beneficiary" treatment.

Even if the trust does qualify, as previously noted, the payout schedule will be less favorable than that available to a surviving spouse named directly (outright) as the participant's beneficiary.

Again, before deciding to name a trust as the beneficiary of your retirement plan, you need to be aware of the potential cost of accelerated income taxes and determine whether that is outweighed by the benefits you derive in naming a trust as your beneficiary. The pros and cons must be evaluated in light of your personal situation and with input from qualified advisors.

The payout period that applies to a trust that is not a conduit trust or grantor trust depends on two factors:

- Whether the trust qualifies for designated beneficiary treatment under the four rules in the regulations, and
- When the participant dies.

If the participant dies before reaching the age when minimum required distributions have to begin being paid out to him from his retirement plan and the trust cannot satisfy all four of the trust requirements, the results are onerous. Within five years of the participant's death, all plan assets must be distributed from the plan to the trust and subjected to income tax.

If the participant dies after minimum required distributions had begun and the trust does not qualify, then minimum required distributions to the trust must continue being paid out based on what would have been the remaining life expectancy of the participant, but not "recalculated." That is, the participant's remaining

life expectancy, based on his birthday in the calendar year of his death, determines the initial divisor, and the number one is then subtracted for each year after that to calculate the proper distribution.

If the trust qualifies for designated beneficiary treatment under the rules, then the life expectancy of the oldest trust beneficiary is used to calculate the minimum required distribution each year. This life expectancy is not allowed to be recalculated.

Regardless of which trust beneficiary's life expectancy is being used (i.e., even if it is the spouse) distributions to the trust must begin by December 31 of the year following the year of the participant's death. Thus, this result is less favorable than the options available to a spouse named directly as a beneficiary, who can delay beginning required distributions when the participant dies before reaching his required beginning date, recalculate his or her life expectancy each year, or exercise the "rollover" option and name new beneficiaries for the rollover IRA.

NAMING CREDIT SHELTER TRUST

Retirement plan assets should be the assets of last resort chosen for your credit shelter trust, since plan assets have a built-in income tax burden. To take an extreme example, say your estate is worth \$2.2 million. You designate \$1,000,000 of plan assets to go to the credit shelter trust, and the remainder of your assets to go to your spouse. Since the \$1,000,000 is subject to income tax, you have effectively only sheltered about \$640,000—the government will take close to one-third of all plan dollars distributed for income taxes!

For estate tax planning purposes, you are always much better off directing assets to your credit shelter trust that have little or no income tax consequences following your death. Ideally, you want after-tax assets with true growth potential to

fund your credit shelter trust.

Should you determine that the estate tax benefits of a credit shelter trust are significant in your case, you may have no alternative but to direct plan assets to this trust (if you have no other available assets).

Fortunately, IRS regulations provide that distributions from the plan to the trust do not have to be immediately distributed to the trust beneficiaries. Therefore, if your spouse does not require the assets to live on, they can be maintained in the trust for future distribution to other heirs, thereby avoiding potential estate tax consequences in your spouse's estate.

Of course, keeping the plan distributions in the trust will mean that the trust will pay the income taxes on them (as opposed to the beneficiaries paying the income taxes on any income distributions they receive from the trust). Since trusts reach a very high income tax bracket very quickly, this may not be desirable.

Also, remember that distributions to the credit shelter trust from the plan will only be made over the trust beneficiary's life expectancy if all four of the trust requirements discussed previously are satisfied. If the four trust requirements are not met, then the distributions to the credit shelter trust may be based on the less favorable five-year distribution period, causing acceleration of income taxes.

NAMING QTIP TRUSTS

The QTIP trust, as mentioned previously, provides a way for you to transfer assets to a trust for your spouse that qualifies for the marital deduction (thereby deferring estate taxes), while providing lifetime benefits to your spouse and maintaining some degree of control over disposition of the remaining trust assets. This is becoming a commonly used tool. However, it is not uncommon to create an estate plan fully sheltering the estate tax exemption amount in a credit shelter

trust, directing the excess assets to a QTIP trust, and still name the spouse as the direct beneficiary of retirement plans. One reason for this is the highly technical nature of the existing rules and the conflict between income tax benefits and estate planning goals and objectives.

A major issue involved in naming the QTIP trust as the beneficiary of retirement plans relates to the federal estate tax requirement that all trust income be distributed from the QTIP trust, to the spouse, at least annually. This could potentially lead to the very acceleration of taxable income that you want to avoid for income tax purposes. As noted previously, however, even though naming a spouse directly as the beneficiary of retirement plans provides the most favorable income tax options, the final regulations provide at least two approved trusts that can be used to obtain a life expectancy payout of the plan assets.

The QTIP trust can either be structured as a conduit trust, or it can be the type of QTIP trust where all of the remainder beneficiaries are identifiable and all are clearly younger than the surviving spouse. In addition, a relatively recent IRS ruling allowed the trustee of a QTIP trust to withdraw solely the minimum required distribution amount from the retirement plan each year (rather than all of the income (earnings) on the trust's interest in the plan), and still qualify for the federal estate tax marital deduction.

Following this method will work for marital deduction qualification purposes as long as the surviving spouse is given the actual QTIP trust income, and as long as he or she has the power to compel the trustee to withdraw the full amount of income earned inside the retirement plan each year. Thus, if the earnings inside the retirement plan are not currently needed by the surviving spouse, a lesser amount can be withdrawn from the plan each year (during the years when the minimum required distribution calculated according to the life expectancy payout method is less than the plan's annual earnings), allowing for greater income tax deferral.

CONCLUSIONS

Although attorneys and financial planners have more legal direction today than several years ago, naming a testamentary trust as a beneficiary of plan assets remains a complex and sometimes uncertain planning strategy.

After all, you don't know when you are going to die; you don't know how long your spouse will survive you; and you don't know what the estate tax exemption amount or the income tax rates will be in the future.

These uncertainties make absolute answers difficult to come by, especially since there are subjective factors involved:

- How strong is your desire to control your assets, including your

retirement plan assets, after your death?

- How important is the protection of your selected heirs' rights to remaining assets?
- How does your spouse respond to the thought of having assets controlled indirectly by you through a trust?
- How old are you relative to your spouse?
- How much of your total estate is made up of plan assets? The list of questions goes on and on.

There is one important issue to be aware of: If you wish to name someone (or something) other than your spouse as the direct beneficiary of your qualified retirement plan assets (this does not apply to IRA or SEP plans), your spouse will need to sign a consent form indicating his or her acceptance and approval. This is done when changing the beneficiary designation for your employer-sponsored qualified plans.

Our explanation of this planning strategy has been necessarily simplified. It is an extremely complex area involving several different tax laws, trust laws and other significant state and federal laws. A proper and thorough analysis should be done to determine if and how this planning might be used in your own situation. The drafting of your legal documents is of critical importance. Only an attorney specializing in the area of estate planning on a full-time basis should be considered for preparing your trusts. Hiring a part-timer in this area is not advisable. ♦