Whose Life Expectancy Is It, Anyway? Determining Which Trust Beneficiaries Are Countable for Required Minimum Distribution Purposes

By Michelle L. Ward

Michelle L. Ward explains the complex rules governing IRA accounts in determining the correct life expectancies to use in calculating required minimum distributions.

Introduction

With retirement assets making up such a large portion of our clients' estates, paying retirement assets to trusts is becoming more and more prevalent. But a trust should not be named beneficiary of an IRA without first carefully considering the provisions of the trust and the requirements necessary to obtain designated beneficiary status. Ascertaining which trust beneficiaries are countable for Code Sec. 401(a)(9) purposes is a vital step in determining if the trust will qualify.

Requirements for Trust Qualification

In order for a trust to be considered a designated beneficiary under the Code Sec. 401(a)(9) regulations governing required minimum distributions (RMDs) from IRAs, the following requirements must be met[1]:

- The trust is a valid trust 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 death of the employee.
- The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable within the meaning of Reg. §1.401(a)(9)-4, A-1 from the trust instrument.
- The documentation described in Reg. §1.401(a)(9)-4, Q&A 6 has been provided to the plan administrator (this requirement can be satisfied by providing a copy of the trust to the plan administrator by Oct. 31 of the year following the year of the owner's death).

If these requirements are satisfied, the beneficiaries of the trust (and not the trust itself) will be treated as having been designated as beneficiaries for purposes of determining the distribution period.[2] Accordingly, the life expectancy of the oldest trust beneficiary can be used to determine RMDs. If the trust does not meet the above requirements, the owner is considered to have no designated beneficiary and the retirement plan must be distributed in five years if the plan owner died before his required beginning date[3] or over the plan owner's remaining life expectancy if he died on or after his required

Michelle L. Ward is a manager in the Financial and Estate Planning Group of Virchow, Krause & Company, LLP, Appleton. Her emphasis is in estate planning with primary focus on retirement distribution planning. She is president of the Association of Women Lawyers of Brown County.

beginning date. This can lead to a tremendous loss of tax deferred growth.

Requirements 1, 2 and 4 are easily met. Most trusts fail to qualify as designated beneficiaries because of the third requirement. While at first blush it may appear simple to identify the beneficiaries of a trust, the analysis is not that straightforward. One must look at *all* potential beneficiaries of a trust to determine (1) if such beneficiaries can be identified by Sept. 30 of the year following the year of death and (2) if such beneficiaries are all individuals with an ascertainable life expectancy.

When drafting a trust, one should examine all possible scenarios that could exist at a person's death. For instance, where would the trust go if the grantor died without any descendants? When a person has died, one only needs to take a snapshot of the potential trust beneficiaries as of Sept. 30 of the year following the year of the IRA owner's death. Knowing the applicable life expectancy can avoid the use of a shorter than expected life expectancy and, more importantly, avoid the loss of designated beneficiary status altogether.

Contingent Beneficiaries

As indicated above, one must look at all potential beneficiaries of the trust, no matter how remote the possibility is that a beneficiary may actually receive benefits from the account. A person will not be considered a beneficiary, however, for purposes of determining who the beneficiary with the shortest life expectancy is, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death. Such beneficiary is referred to as a "mere potential successor." However, this rule does not apply to a person who has any right (including a contingent right) to an employee's benefit beyond being a mere potential successor to the interest of one of the employee's beneficiaries upon that beneficiary's death.[4] Therefore, if benefits will not accumulate in trust for a particular beneficiary under the facts existing at the IRA owner's death, any contingent beneficiary taking as a result of such beneficiary's death is disregarded. In essence, one would keep going down the beneficiary line to determine the oldest potential beneficiary until there comes a point when the trust would be distributed outright.

Example 1. Alexander creates a trust for the benefit of his son, Nicholas. At Nicholas' death, the trust is distributed to grandchildren as long as the grandchildren are age 18. If a grandchild dies before age 18, their share is distributed to such grandchild's estate. If Alexander has one grandchild at his death and that grandchild has reached age 18, any contingent beneficiary beyond the grandchild is disregarded. Therefore, Nicholas, as the oldest beneficiary, would be the measuring life for determining RMDs. If, however, any grandchild was not yet age 18 at Alexander's death, the trust would not qualify as a designated beneficiary because an estate (*i.e.*, a nonindividual) is a potential beneficiary.

Example 2. Melissa creates a trust for the benefit of her three children. The trust distributes to each child at age 40. Each child is younger than 40 at Melissa's death. If a child dies before age 40, the trust is payable for the benefit of such child's issue or in default to Melissa's issue. Any trust created for an issue is held in trust until such issue turns age 40. If there are no such living beneficiaries, the trust is payable outright to Melissa's older brother, James. The same distribution pattern is followed for any issue who dies before age 40. Because the first time the trust is going to pay outright (based on the facts as they exist at Melissa's death) is to James, he is the last beneficiary that needs to be considered. Therefore, James' age will be used in determining RMDs because he is the oldest countable beneficiary.

Example 3. Same facts as Example 2 except that when Melissa dies, one of her children, Linda, is 45. For the shares for children who are younger than 40, Linda is a potential beneficiary (if the child dies without issue and the other sibling is deceased). Therefore, since at the point that Linda could receive the benefits the trust is distributed outright to her, the analysis can end there and Linda (as the oldest child) is the measuring life for determining RMDs.

Conduit Trusts

The examples under Reg. §1.401(a)(9)-5, A-7 illustrate that a beneficiary of what is commonly referred to as a "conduit trust" is also a mere potential successor. In this context, a conduit trust is a trust that requires the trustee to distribute to the trust beneficiary any and all amounts withdrawn from the IRA. Thus, in a conduit trust, IRA assets are not allowed to accumulate in trust (outside of the IRA wrapper) for future beneficiaries.

To illustrate this point, let us say that under the terms of Trust A, any and all amounts that the trustee withdraws from retirement accounts payable to the trust must be immediately distributed to the primary beneficiary, Child A. In other words, Trust A is a conduit trust. Child A is given a testamentary general power of appointment.[5] If the trust were *not* a conduit trust, the fact that the child is given a general power of appointment would disqualify the trust as a designated beneficiary because not only is a nonindividual a potential beneficiary of the trust (*i.e.*, an estate or a creditor), but by Sept. 30 of the year following the year of the IRA owner's death, it would not be possible to determine who is the oldest potential beneficiary of the trust. However, because the trust *is* a conduit trust, any beneficiaries beyond Child A can be disregarded in determining whose life expectancy is used and if the trust qualifies as a designated beneficiary.

> When a person has died, one only needs to take a snapshot of the potential trust beneficiaries as of Sept. 30 of the year following the year of the IRA owner's death.

Using a conduit trust can be a useful tool when the grantor wishes to name a charity or an older relative as a contingent beneficiary of the trust. It also tends to eliminate many of the traps that exist in trying to draft an accumulation trust to qualify as a designated beneficiary. While a conduit trust does not provide maximum spendthrift protection, it does provide a safeguard against the beneficiary taking accelerated payments from the IRA—a protection that would not exist if the trust beneficiary were named outright beneficiary of the IRA.

Separate Shares

Generally, when multiple beneficiaries are named, RMDs are based on the life expectancy of the oldest beneficiary. If, however, separate shares are created by Dec. 31 of the year following the year of death, each beneficiary can use their individual life expectancy for determining RMDs from their respective share. Such separate share treatment is not available when a trust is named beneficiary of an IRA, even if the trust and IRA are divided into separate shares upon the death of the grantor/IRA owner.[6] There is a way around this rule, however. If, instead of simply naming the main trust as beneficiary of the IRA, the separate trust shares are named specifically as beneficiaries, the separate share rule is available to trust beneficiaries.

Example 4. Linda Smith has two sons, Trevor (age two) and Garrett (age 12). Linda wants to name her trust (Smith Trust) as beneficiary of her IRA. Upon Linda's death, the trust divides into two separate shares—one for each son. If Linda completed her IRA beneficiary designation form to simply say "100 percent to the Smith Trust" the IRA in both trust shares would have to utilize Garrett's life expectancy to determine RMDs. If, instead, Linda completed her beneficiary designation form to state "50 percent to Trevor Smith's Trust as created under the Smith Trust and 50 percent to Garrett Smith's Trust as created under the Smith Trust," Trevor could use his life expectancy for his trust's share of the IRA and Garrett could use his life expectancy for his trust's share of the IRA (as long as the IRA was separated by Dec. 31 of the year following the year of Linda's death).[7]

Even if this planning technique is used, however, the older beneficiary could still be a potential beneficiary of the other share, resulting in the oldest beneficiary's life expectancy being used regardless of how the beneficiary designation form is structured.

Example 5. Assume the same facts as Example 4, except that Garrett and Trevor are contingent beneficiaries of their brother's trust share. Unless the trust is a conduit trust, Garrett is a potential beneficiary of Trevor's share and thus is the oldest beneficiary of each trust share.

This can be avoided by limiting contingent beneficiaries of each trust share to those individuals no older than the primary beneficiary of the separate share. Care must be taken when limiting beneficiaries in this manner, however, so as to prevent unintentionally eliminating a beneficiary, such as an older child, as contingent beneficiary of a trust share.

Disclaimer or Payout

The oldest beneficiary is determined based on the trust beneficiaries as of the date of the IRA owner's death who remain beneficiaries as of Sept. 30 of the calendar year following the calendar year of the employee's death.[8] Consequently, any person who was a beneficiary as of the date of the IRA owner's death, but is not a beneficiary as of that Sept. 30, is not taken into account in determining the oldest trust beneficiary. Accordingly, if a person disclaims entitlement to the employee's benefit, pursuant to a disclaimer that satisfies Code Sec. 2518 by that Sept. 30, the disclaiming person is not taken into account in determining the employee's designated beneficiary. Likewise, if a trust beneficiary is "cashed out" of the trust by Sept. 30 of the year following the year of death, such beneficiary is disregarded in determining the oldest beneficiary.

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Example 6. Robert creates a trust for the benefit of his brother, Carl. Upon Carl's death, the trust is paid out to Carl's issue. Carl executes a qualified disclaimer of his interest in the trust. Carl is no longer considered a beneficiary of the trust for identifying the oldest trust beneficiary.

Example 7. Juanita creates a trust providing an outright bequest of $10,000 to the Salvation Army, with the remainder to her issue. Generally, the bequest to the Salvation Army would taint the entire trust from qualifying as a designated beneficiary because it does not have a measurable life expectancy. However, if the $10,000 bequest is satisfied by Sept. 30 of the year following the year of Juanita's death, the Salvation Army can be disregarded for RMD purposes.

These disclaimer and payout provisions are useful in the postmortem planning stage to eliminate undesirable, nonindividual, beneficiaries or to utilize the life expectancy of a much younger beneficiary.

Death of a Beneficiary

Despite the rule mentioned above, if a beneficiary dies after the IRA owner, but before Sept. 30 of the year following the year of the death of the IRA owner (without disclaiming), such beneficiary continues to be treated as a beneficiary for purposes of identifying the oldest trust beneficiary.[9]

Example 8. Keith creates a trust for the benefit of his daughters, Lydia, age 42, and Olivia, age 36. Keith dies in July 2008 and Lydia dies in October 2008. Because Lydia was alive at Keith's death, she is still the oldest beneficiary of the trust for purposes of determining RMDs.

Conclusion

Drafting a trust to qualify as a beneficiary of a retirement account can be a difficult task, but if the drafter understands the rules stated above, he or she is off to an excellent start in obtaining the client's desired results.

Endnotes

1 Reg. §1.401(a)(9)-4, Q&A 5(b).
2 Reg. §1.401(a)(9)-4, Q&A 5(a).
3 Generally, the required beginning date is April 1 of the year following the year the owner reaches age 70½. Reg. §1.401(a)(9)-2, Q&A 2(a).
4 Reg. §1.401(a)(9)-5, A-7(c).
5 Under Code Sec. 2041(b)(1), the term "general power of appointment" means a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.
6 Reg. §1.401(a)(9)-4, Q&A 5(c). See also LTR 200349009 (Sept. 3, 2003).
7 This planning method was confirmed in LTR 200537044 (March 29, 2005).
8 Reg. §1.401(a)(9)-4, Q&A 4(a).
9 Reg. §1.401(a)(9)-4, Q&A 4(c).