

# IRA and Qualified Retirement Plan Beneficiary Designations: Techniques for Estate Planners to Avoid Costly Errors

Identifying, Avoiding, and Correcting Designation Problems With Tax and Non-Tax Consequences

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# Overview of Retirement Plan Distributions

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# Seismic Change: The SECURE Act

- Effective 1-1-2020
- Replaces death-time life expectancy payout with a 10 year payout for all but 5 categories of beneficiary
  - Surviving spouse
  - Minor children of participant
  - Disabled beneficiary
  - Chronically ill beneficiary
  - Beneficiary less than 10 years younger than participant
- Age for starting MRDs raised to 72 instead of 70-1/2
- Age cap for contributing to a traditional IRA removed

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# Overview of Retirement Plan Distributions

- Traditional IRA
  - Contributions are income tax deductible in the year of contribution
  - Withdrawals are subject to income tax
  - Distributions can be made penalty free at 59 ½
  - 10% penalty on early withdrawals (plus payment of income tax)
  - OLD RULE: Required minimum distributions (RMD) begin at 70 ½. **NEW RULE UNDER SECURE ACT: RMDs BEGIN AT AGE 72**
  - OLD RULE: No contributions past 70 ½. **SECURE ACT REPEALS THIS RULE.**

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# Overview of Retirement Plan Distributions

- Required Minimum Distributions
  - Mandate timing and amount of withdrawals
  - Cover account owners and their beneficiaries
  - Goal: Minimize payouts to maximize deferral. **SECURE ACT GREATLY DIMINISHES OPPORTUNITY TO MINIMIZE PAYOUTS AT PARTICIPANT'S DEATH, AS WE WILL DISCUSS**
  - Penalty: 50% of amount not withdrawn



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# Distributions During Participant's Life

- Required Minimum Distributions for the Plan Participant
  - Value of account on December 31 of prior year
  - Divided by the “Applicable Divisor” for current year
  - The “Applicable Divisor” is based on the “Uniform Lifetime Table”
    - Example:
      - Applicable divisor at age 76 is 22 years.
      - If participant has a \$2.2 million IRA, her M RD for that year would be \$100,000

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# Distributions at Death

- Non-Individuals
- Non-Spouse Individuals
- Spouse
- Trusts

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# Distribution at Death – General Rule

- Non-Individuals – 5 Year Rule is Still In Effect
  - If Participant died before RBD, all funds must be withdrawn by December 31 of the fifth calendar year following the calendar year of the Account Owner's death
  - If Participant died on or after RBD, funds must be withdrawn over Participant's remaining life expectancy
- Examples:
  - Participant dies at age 65 naming his estate as beneficiary. Estate must take distribution within 5 years
  - Participant dies at age 76 naming her estate as beneficiary. Estate may take distributions over participant's remaining life expectancy of 12.7 years



# Designated Beneficiaries

1. Designated beneficiaries must be individuals.
2. If a charity, estate, LP, LLC or corporation is named as a beneficiary then there are no designated beneficiaries.
3. The designated beneficiaries are determined on **September 30<sup>th</sup>** of the calendar year following the calendar year of the IRA owner's death. Solution: separate accounts, cash out or disclaimer before the September 30<sup>th</sup> determination date.

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# Distribution at Death of Participant for “EDBs”

- Non-Spouse Individuals Who Qualify as “Eligible Designated Beneficiary”
  - Old rules apply
  - Is Beneficiary older than original account owner?
    - No: RMD based on Beneficiary’s Life Expectancy
    - Yes: Did the account owner die before RBD?
      - No: RMD based on Beneficiary’s Life Expectancy
      - Yes: RMD based on Decedent’s Life Expectancy
- Non-Spouse Individuals Who Do Not Qualify as EDB
  - Use 10 Year Rule

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# Who Qualifies as an EDB?

- Exceptions for certain beneficiaries (“eligible designated beneficiary”)
  - Surviving Spouse
  - The Participant’s **children** under the age of majority (*not grandchildren or any other children*)
  - Disabled
  - Chronically ill
  - Individual not more than ten years younger than participant

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# Distribution at Death – Spouse as Beneficiary

- Spouse
  - Spousal Rollover
    - Old rule: Surviving spouse takes RMD at **70 ½** (Uniform Life Table)
    - **New rule: Surviving spouse takes RMD at 72 (Uniform Life Table)**

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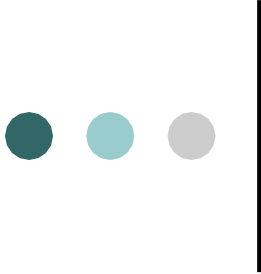
# Distribution at Death – Spouse as Beneficiary

- Spouse
  - Inherited IRA
    - Owner died after RMD – whichever is longer each year
      - RMD on surviving spouse life expectancy (SLT)
      - RMD based on decedent's life expectancy (SLT)
    - Owner died before RBD: RMD at decedent's 72 on spouse's life expectancy (single life table)



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# Using Trusts as Beneficiaries of Retirement Benefits



# Why would you want to have a Trust as a beneficiary of your IRA?

- i. Beneficiary is a spendthrift
- ii. Second spouse and children from a prior marriage
- iii. Creditor protection for beneficiary
- iv. Protection against spouse in a divorce
- v. Special Needs Trust to be eligible for government based funding
- vi. Beneficiary is a minor
- vii. Benefit from the “Stretch-out” over the beneficiary’s life expectancy  
If you name the beneficiary as an outright beneficiary of the IRA then more likely than not (80%) the beneficiary will cash out the IRA and forgo the benefits
- viii. “Dead-hand” control
- ix. Estate tax planning



# Can you have a Trust as a beneficiary?

YES! However, the Trust must meet five (5) requirements

Generally only *individuals* can be named as beneficiaries of an IRA. However if the Trust meets the following requirements it can be named as a beneficiary and take advantage of the “stretch-out.”

1. Trust must be valid under state law
2. Trust is irrevocable upon death of owner
3. Beneficiaries of the Trust are identifiable from trust instruction
4. Documentation requirement is satisfied
5. Designated Beneficiaries are individuals\*

\* Important when we want to determine the beneficiary whose life expectancy we will be using to determine the RMD.

If the trust meets the above requirements, then allowed to “look through” the named trust to the underlying beneficiaries and use their life expectancies.



# Paying IRAs to Trusts

## Four Requirements for **ALL** Trusts

1. Trust is valid under state law
  - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(1)
2. Trust is irrevocable upon death of owner
  - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(2)
3. Beneficiaries of the trust are identifiable from the trust instrument
  - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(3)
4. Documentation requirement is satisfied
  - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(4)



# Trust Must be Valid Under State Law

1. Trust must be legally formed under state law- easily satisfied
2. Testamentary trust created pursuant to a Will is allowed
3. Treas. Reg. §1.401(a)(9)-4, Q&A 5(b)(1)



# Trust is Irrevocable Upon Death of the Owner

Joint Living Trust may be difficult to satisfy as the IRS views the Trust as one trust (see PLR 200317044). Survivor's Trust is revocable.\*

When working with a Joint Living Trust define the IRA beneficiary as a sub-trust to be created under the Joint Living Trust.



# Documentation Requirement is Satisfied by October 31

1. IRA owner or Trustee of beneficiary must provide IRA Trustee or custodian with:
  - a copy of the Trust by October 31st of the calendar year following the calendar year in which the IRA owner dies OR a list of all trust beneficiaries as of September 30th of the calendar year following the year in which the IRA owner dies, and agree to provide a copy of the trust instrument on demand
2. §1.401(a)(9)-4, Q&A 5(b)(4)
3. The documentation required to be furnished is set forth in Reg. §1.401(a)(9)-4; A-6(b)



# Beneficiaries of the Trust are Identifiable from the Trust Instrument

The beneficiaries should be identified by name or identified as a member of a “class” of beneficiaries (i.e. my children or grandchildren)

Treasury Regulation §1.401(a)(9)-4, Q&A 5(b)(3)



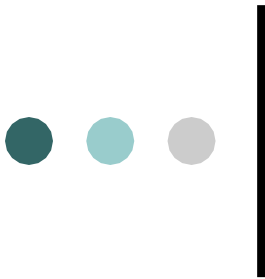


# Naming a Trust as a Beneficiary

General Rule: Use the life expectancy of the oldest beneficiary

-Exception: creation of sub-trusts as separate accounts

1. If you create sub-trusts for each beneficiary then allowed to use that beneficiary's life expectancy to determine RMD
2. The separate treatment can be advantageous for younger beneficiaries who can stretch out RMD over a longer period of time



# Conduit Trust VS Accumulation Trust



# Conduit Trust

1. Trust **REQUIRES** that the trustee pay **ALL** amounts received from the plan to the beneficiary.
2. In such a case, the IRS considers the conduit trust beneficiary the sole beneficiary disregarding all potential successor beneficiaries.
  - a. Example: Trust for the benefit of the spouse and the Trustee must distribute all distributions from the plan to the spouse outright. The spouse is the sole designated beneficiary.
  - b. Many times the purpose of placing the IRA in Trust is to avoid having to pay the distribution out directly to the beneficiaries therefore a conduit trust may not be practical.



Paying IRAs to Trusts

# Conduit Trust

Allows for easier identification of beneficiaries



Paying IRAs to Trusts

## **Conduit Trust**

Lineal descendants can be ignored because all distributions are paid through the trust to Child #1.



# Accumulation Trust

1. If a trust is not a conduit trust then it is an accumulation trust. The Trustee has the ability to accumulate distributions it receives from the plan.
2. Payment to a Trust qualifies as distribution for purposes of the RMD rules, therefore the trust is not required to redistribute the payments to a beneficiary. As a result, the Trustee can accumulate distribution until a certain age or need.
3. The Designated Beneficiary gets complicated, careful drafting is required to make certain you are maximizing the benefit of the “stretch-out.”



# Paying IRAs to Trusts

## **Accumulation Trust**

The key issue in analyzing an accumulation trust is to determine which beneficiaries are “countable.”

All beneficiaries are countable unless such beneficiary is deemed to be a “mere potential successor” beneficiary.



# Paying IRAs to Trusts

## Common Mistakes to Avoid

- Older or unidentifiable contingent beneficiary
- Estate as contingent beneficiary
- Powers of appointment
- Failure of beneficiaries clause
- Failure to provide trust document to custodian by October 31 of year following year of death
- Making lump sum distribution to trust
- General powers of appointment
- Tax issues
- Asset protection issues





# How to Fix “Broken” Irrevocable Trusts

- If no solutions are found in the trust document, consider:
  - Decanting
  - Judicial Modification
  - Non-Judicial Modification



# Paying IRAs to Trusts

## **Reforming Beneficiary Designations**

- PLR 200616039-41 - Daughter's life expectancy could be used. Even though no contingent beneficiaries were named, court reformed beneficiary designation to name daughters as contingent beneficiaries of IRA.
- IRS is currently rethinking this position.



# Paying IRAs to Trusts

## Disadvantages of Utilizing a Trust

- Trust tax rates
  - If Trust is not a “conduit” Trust and instead an “accumulation trust” then pays tax at the higher rates. A complex trust is taxed at 39.6% when it has income over \$12,300.
- Legal and trustee fees
- Trust income tax returns
  - 1041
  - 1099
  - K-1
- Greater complexity



# Are RMDs considered DNI?

- All items of IRD are considered DNI
- Retirement Plan distributions are considered IRD
- Therefore retirement plan distributions received by a trust are considered as DNI
- IRC Section 643(a), Reg. Section 1.663(c)-5, Examples 6 and 9
- However, this does not necessarily mean that a distribution carries out DNI



# Six Hurdles to Overcome

Trust is entitled to an income tax deduction for retirement plan distributions it makes from DNI to beneficiary if following requirements are met:

1. The beneficiary must be entitled to receive the money – drafting important.



# Six Hurdles to Overcome

2. DNI deduction is only available for gross income that is either required to be distributed or is actually distributed in same taxable year (or within 65 days of end of taxable year, if special election is made). Thus, if discretionary distributions, must make the distribution in time.



# Six Hurdles to Overcome

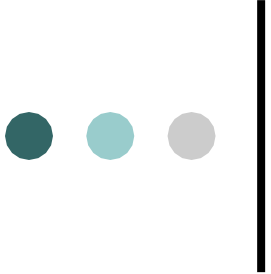
3. If there are 2 or more beneficiaries and then have “substantially separate and independent shares” a distribution to one beneficiary will not carry out DNI that is allocated under the separate share rule to a different beneficiary.



# Six Hurdles to Overcome

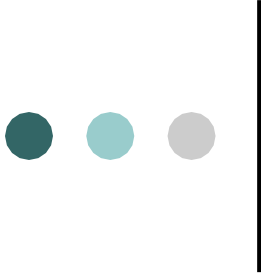
4. Transfer of the Retirement Plan, itself, does not carry out DNI.
5. The Trust generally does not get a DNI deduction for distributions to charity.
6. The DNI distribution is not available for distributions in fulfillment of a special sum or a pecuniary bequest, thus if bequest is to pay 10k to grandchild, that bequest does not carry out DNI.





# Trust Accounting Vs. Federal Income Tax

- An RMD general will be gross income for income tax purposes, but that same RMD may be principal or corpus for trust accounting purposes.
- RMDs and Trust accounting income are totally different and unrelated concepts.



# Trust Accounting Vs. Federal Income Tax

Unless the Trust has own definition, then must look to state law to determine what part of RMD is considered income and what part is considered principal or corpus.



## Uniform Principal and Income Act

- Allocation of Receipts During Administration of Trust
- A trustee shall allocate to income an amount received as a distribution of income from a trust or an estate in which the trust has an interest other than a purchased interest.
- A trustee shall allocate to principal an amount received as a distribution of principal from such a trust or estate.
- An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under Section 409(c).



## Section 409(c) UPIA

- 10% of the amount of the RMD received is allocated to income.
- The balance is allocated to principal.
- Each state has its own version of UPIA—check your own state!



## How to Draft

- If Conduit Trust, then must pay RMDs to beneficiary and distributions carry out DNI.
- If Accumulation Trust, then must be careful when drafting in order to make sure distribution carries out DNI.
- In order for Trust to get DNI deduction the Trust must give Trustee discretion to distribute principal (or at least that part of principal that is RMDs).



## Drafting Solutions

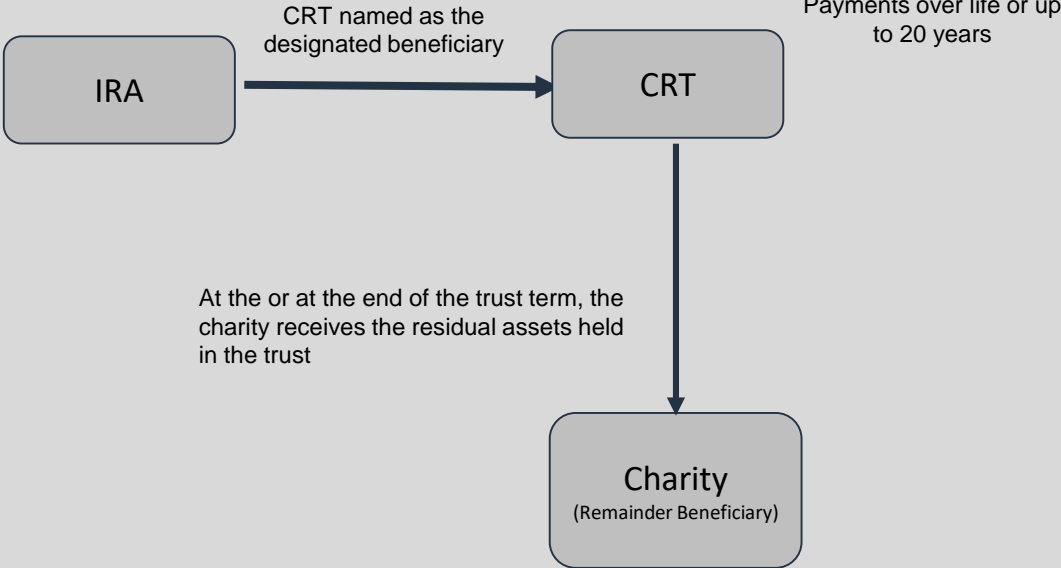
- Draft so the definition of income does not matter, i.e., trustee shall pay such amounts of income or principal that the trustee deems desirable from time to time.
- Draft own definition of income, i.e., can state that all retirement plan distributions to trust are considered income (but if require all income to be paid out, then this could be problematic).
- Treat the retirement plan as a trust within a trust, typically done to qualify a marital trust which holds an IRA, require that the IRA pay to the trust greater of income of trust or RMD, and then require that trust distribute income of IRA to spouse.

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# Charitable Remainder Trust Basics

- Irrevocable trust
- Income stream payable to one or more noncharitable beneficiaries
  - Annuity or unitrust interest
  - For life or for a fixed term
- Remainder interest payable to charity
- Estate receives charitable deduction for actuarial value of remainder interest
- Income and gains not taxable in trust

# Charitable Remainder Trust as Beneficiary





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# Benefit of Charitable Remainder Trust as Beneficiary

- Estate tax deduction for charitable remainder interest
- “Synthetic Stretch” of payout from account
  - Example: \$1,000,000 IRA passing to CRT for 50 year old beneficiary could pay out \$50,000 per year for life (34 year expectancy) versus \$100,000 per year under 10 year rule
  - Defers income tax over life of beneficiary instead of only 10 years
  - Produces estate tax charitable deduction of \$261,000, saving estate taxes of \$104,400
- Consider life insurance to replace wealth passing to charity at end of term

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# Wealth Replacement Insurance Trust

- Participant establishes “Wealth Replacement Trust”
- Trust purchases insurance on life of beneficiary
- If structured properly, insurance is excluded from estate



# What Laws Govern IRAs

- Federal Law:
  - IRC §408 and §408A – Requirements
  - IRC §401 – Distribution Rules
  - Other Tax Law – Income Tax, Estate Tax, GST
  - Bankruptcy Law
  - Private Letter Rulings, Revenue Rulings, etc.



## What Laws Govern IRAs (continued)

- State Law:
  - Uniform Principal and Income Act
  - Guardianship
  - Intestacy
  - Elective Share, Common Law, Divorce
  - Asset Protection
  - Case Law



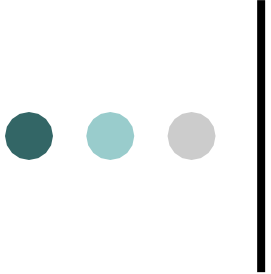
## What Laws Govern IRAs (continued)

- IRA Agreement:
  - Beneficiary default language (estate versus surviving spouse)
  - Per stirpes versus per capita
  - Payout options during lifetime and post-mortem
  - Governing law
  - Arbitration clauses



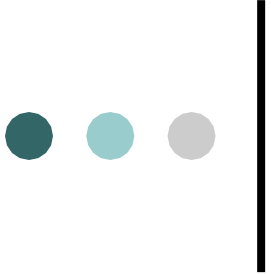
## What Laws Govern IRAs (continued)

- State Law:
  - Uniform Principal and Income Act
  - Guardianship
  - Intestacy
  - Elective Share, Community Property and Divorce
  - Asset Protection
  - Power of Attorney
  - Case Law



## State Laws (continued)

- Uniform Principal and Income Act – most states amended in 2009 to address issue with marital deduction in response to Revenue Ruling 2006-26.
- Guardianship:
  - Minors: an account in excess of \$15,000 left to a minor outright instead of in trust will need to be supervised through a guardianship (varies by state);
  - Incapacity: IRAs held by individuals that have been adjudicated and determined to be incapacitated will be governed by a guardianship unless there is a specific DPOA in place recognized by the court as a “less restrictive means”.



## State Laws (continued)

- Intestacy – if no beneficiary designation and no will, state statutes will determine IRA beneficiaries.
- Elective Share or Community Property – IRAs and QRPs are subject to the elective share, or alternatively community property laws.
- Asset Protection – IRAs and QRPs are protected by state statutes in addition to BAPCPA.
- Case Law





## What Controls if there is a Conflict?

- Sometimes federal law control;
- Sometimes state statutes control;
- Sometimes contractual provisions control;
- Sometimes case law controls.



## A Few Final Thoughts on Trusts:

- Be sure to designate sub-trusts specifically on the beneficiary form - Do not make the IRA payable to the master trust but rather list specific subtrusts and the percentage or fraction that each sub-trust will inherit.
- Plan for contingencies. Leave an exit strategy. If the plan is to leave it to a trust with income for life to the surviving spouse and then to children, specify on the beneficiary form “If my spouse survives me, I designate the John Smith Trust as beneficiary of my IRA. If my spouse does not survive me, then I designate my children as beneficiaries of my IRA in equal shares.”

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# Estate Tax Impact of Retirement Benefits

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# Estate Tax Impact of Retirement Benefits

- Assume \$20,000,000 estate
- Assume \$10,000,000 IRA
- Child A gets IRA
- Child B gets liquid assets

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# Estate Tax Impact of Retirement Benefits

- Assume \$20,000,000 estate
- Estate Tax = \$3,528,000
- If each child bears tax burden:
  - Each owes \$1,764,000 in estate taxes
  - Child A takes \$1,764,000 distribution and pays income tax of \$652,680

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# Estate Tax Impact of Retirement Benefits

- Highlights:
  - Consider the tax impact when planning
  - Review tax clauses in Wills

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# Beneficiary Designations



# How to Fix a Beneficiary Designation

1. Disclaimer – must meet the requirements of IRC §2518 for a qualified disclaimer.
2. Cash out before September 30<sup>th</sup>  
IRA owner left his IRA benefits to his revocable living trust. The beneficiaries of the Trust were children and a charity. Charity is not an individual therefore no designated beneficiary. If the Trust has other assets and the ability to distribute assets non-pro rata then the trustee can satisfy the church's share without assets. If this is done before September 30<sup>th</sup> then the charity is not counted as a designated beneficiary.
3. Separate accounts.





## Executive Order:

On August 31, 2018, the president signed an executive order, which directed Treasury to consider regulatory changes to retirement plans which included updating life expectancy and distribution tables to reflect current mortality data.



# Proposed Regulations Issued: 11/08/2019

## Proposed Transitional Rules

**Lifetime RMDs:** The proposed life expectancy tables first apply to 2021 RMDs

- If an individual attains 70.5 in 2020: The current life expectancy factor is used to calculate the first RMD due 4/1/21
- The proposed life expectancy factor is used to calculate the second RMD due 12/31/21



## Proposed Transitional Rules

**Post-mortem RMDs: Non-Spousal Qualified Designated Beneficiaries –Recall how the computation works:** The post-mortem divisor used to calculate RMDs is computed by using the “subtract-one” method

The beneficiary’s life expectancy is determined using the single life table in calendar year of the employee’s death and the divisor for a given year is determining by subtracting one for each year subsequent to the employee’s death



## Proposed Transitional Rules

**Post-mortem RMDs: Non-Spousal Qualified Designated Beneficiaries** – 2021 RMDs must be recomputed under the proposal: The life expectancy of the beneficiary in the year after the employee's death must be replaced with the new proposed life expectancy

The years subsequent to the employee's death must be subtracted to determine the 2021 divisor.



## Proposed Transitional Rules

**Post-mortem RMDs:** Example from the proposed regulations for non-spousal qualified designated beneficiaries: Employee dies in 2018 at age 80 with a non-spousal beneficiary who was age 75 at the time

In 2019 the divisor is 12.7

- (the beneficiary is 76 when the post-mortem RMD is required so the divisor is the figure from the table for a 76 year-old)

In 2020 the divisor is 11.7 ( $11.7 = 12.7 - 1$ )

In 2021 the divisor is 12.0

- (the life expectancy for a 76 year-old is 14 under the proposed table and 2 years have passed since death:  $14 - 2$ )



## Proposed Transitional Rules

### **Post-mortem RMDs: “Ghost” Life Expectancy**

**Distributions Recall:** This method applies to when the employee dies after the RBD without a designated beneficiary or after the RBD with an older designated beneficiary

The proposal requires that RMDs are adjusted to reflect the new table beginning in 2021

The re-computation method from the prior example appears to control



## Penalty Avoidance

Reliance on a Professional Advisor, is generally cause to request Reasonable Cause penalty relief

The taxpayer must establish exercise of ordinary business care and prudence in determining its tax obligations, but nonetheless failed to comply

Three part test when relying on a professional advisor. The advisor was competent and had sufficient expertise;

The taxpayer provided the necessary and adequate information to the advisor; and

The taxpayer relied in good faith on the advisor.

*Neonatology Assocs., P. A. v. Comm'r*, 115 T.C. 43 (2000).

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