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## *Naming a Trust as the Beneficiary of a Qualified Retirement Plan or IRA*

*Naming a trust as the beneficiary of a qualified retirement plan or IRA can further a client's estate planning objectives. But it carries disadvantages as well. This column explores both the disadvantages and benefits.*

**By Barbara Freedman  
Wand**

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**O**ne consequence of the robust economy of recent years has been the prodigious growth in value of retirement plan assets. For that reason, advising clients regarding the appropriate beneficiary designation for these assets has become an increasingly important part of the estate planning process.

This column will explore the circumstances in which it may be appropriate to name a trust as the beneficiary of a qualified retirement plan or individual retirement account (IRA). For convenience, in this article qualified plans and IRAs will be collectively referred to as "retirement plans." The advantages and disadvantages of trusts as beneficiaries will be explored, and the requirements for obtaining favorable income and estate tax treatment for plan benefits when a trust is named as the beneficiary will be discussed.

### **Reasons for Naming a Trust as the Beneficiary of a Retirement Plan**

In great part, the reasons for naming a trust as the beneficiary

of a retirement plan asset do not differ from the general reasons why a client may choose to leave any assets in trust rather than outright to a beneficiary.

#### **Investment Management**

Where a client has a self-directed retirement plan of significant value and a spouse with no interest or expertise in financial matters, the client may decide that a trust vehicle should be used to remove the burden of investment decisions from the ultimate beneficiary. Where the beneficiaries are young children, similar considerations may lead to naming a trust as the beneficiary.

#### **Protecting Assets from a Spendthrift**

In situations in which a client has concerns about a beneficiary's good judgment in decision making regarding spending, naming a trust as the beneficiary of retirement plan assets creates a buffer between the ultimate beneficiary and the retirement account.

#### **Dealing with Second Marriages**

While naming a spouse as the outright beneficiary of a retire-

ment plan has several significant advantages, including the spouse's ability to roll over the retirement plan benefits into an IRA of his or her own (thus providing potential for additional tax deferral), it also gives the spouse the ability to dispose of the plan assets to whomever he or she chooses, both as to distributions taken during the lifetime of the spouse and by beneficiary designation with respect to the remaining plan benefits at the spouse's death. This result may be acceptable in the case of a first marriage where the children of the plan owner and spouse are the natural objects of the bounty of both spouses.

In a situation, however, in which a plan owner (herein sometimes referred to as the "participant") may have a second spouse and several children from a first marriage, the plan owner may want the surviving spouse to benefit from the plan assets after the death of the plan owner, but may also want to assure that the children from the first marriage will receive the remaining plan assets following the death of the surviving spouse. Directing plan benefits to a marital trust for the benefit of the spouse with the remainder passing to the children of the first marriage at the death of the surviving spouse can accomplish the goals of a client in such a situation. In situations in which qualifying benefits for the marital deduction is necessary for tax deferral, special care must be taken when naming a trust as beneficiary, since obtaining the estate tax marital deduction for the full value of the retirement plan asset requires compliance

with a number of requirements, which will be discussed in detail in a future column.

### ***Making Full Use of the Applicable Exclusion Amount to Avoid Estate Taxes***

A primary goal of estate planning is to make full use of the federal applicable exclusion amount that permits assets to pass tax-free upon the death of an individual. The applicable exclusion amount is \$650,000 for decedents dying in 1999. This amount increases between now and 2006 to \$1 million.<sup>1</sup>

A frequently used vehicle to allow full use of the applicable exclusion amount upon the death of the first spouse to die is the family trust, also often known as the credit shelter trust. The beneficiaries of this type of trust can be the spouse and issue of the decedent and any other individuals (such as parents of the decedent) whom the decedent wishes to benefit. The use of a trust for the applicable exclusion amount allows a surviving spouse to benefit from the assets in the trust, but without giving the surviving spouse so much control over the trust as to subject the trust property to estate taxation at the death of the surviving spouse.

As will be discussed below, retirement assets may not be the optimal assets for the use of the applicable exclusion amount. There may be situations, however, in which a client does not have sufficient nonretirement assets with which to fully use the applicable exclusion amount. In such a situation, the client may need to consider naming the credit shelter trust as the benefi-

ciary of some of the retirement benefits.

### **Disadvantages of Naming a Trust as the Beneficiary of Retirement Plan Assets**

#### ***Potential Loss of Maximal Income Tax Deferral***

One of the important advantages of qualified retirement plan assets derives from the fact that the growth on plan assets is not taxed until distributions are taken from the plan or account. To prohibit plan participants from using plans as a mechanism for passing wealth on to the next generation, rather than as a source of income during retirement, Internal Revenue Service (IRS) regulations require plan participants to take required minimum distributions from qualified plans and accounts once they reach the "required beginning date described in the regulations."<sup>2</sup>

The required minimum distribution is based upon the participant's life expectancy, but if the participant had named a "designated beneficiary" as of the required beginning date, the minimum distribution can also be based upon the life expectancy of the designated beneficiary through the use of a joint life expectancy with the participant. Since a joint life expectancy is almost always longer than a single life expectancy, where there is no designated beneficiary and therefore the participant or IRA owner must withdraw benefits over his or her single life expectancy, the plan or account balance will be diminished by larger required minimum distributions than if there had been a designated beneficiary.

According to IRS regulations, a designated beneficiary must be an individual.<sup>3</sup> Estates and trusts are not individuals and cannot be designated beneficiaries. IRS proposed regulations have provided a method by which one may "look through" a trust to use the beneficiaries of the trust as designated beneficiaries for purposes of the determination of the required minimum distributions. These requirements will be described in detail below. Unless these requirements are complied with, however, naming a trust as the beneficiary of a retirement plan or account will not permit the owner of the plan or account to obtain maximum benefit from the income tax deferral provided by qualified retirement plans.

The loss of maximal income tax deferral that may result by naming a trust as the beneficiary of a qualified plan can affect not only lifetime distributions to the participant but also distributions to the participant's beneficiaries after his or her death. Qualified retirement plan assets are income in respect of decedent, meaning that after the decedent's death the assets retain the same income tax consequences when received by the beneficiary as they would have had in the hands of the decedent. Facing income tax liability for distributions when they are made from the plan and benefiting from the tax deferral on growth of assets within the qualified plan, those entitled to receive distributions from retirement plans after the death of the participant can benefit from minimizing the amounts that must be withdrawn from these tax-deferred assets.

Minimum distribution rules, however, apply not only with respect to distributions during the lifetime of the participant but also to distributions to the participant's beneficiary after the death of the participant. If a participant dies after his or her required beginning date, then the beneficiary must withdraw the remaining plan benefits at least as rapidly as under the minimum distribution method being used during the lifetime of the participant.<sup>4</sup> It follows that if the participant had named a trust as the beneficiary of plan benefits and the trust did *not* qualify for "look-through" treatment, the beneficiary will be forced to withdraw the remaining benefits over the remaining life expectancy of the participant. If the participant elected to recalculate his or her life expectancy,<sup>5</sup> that life expectancy would be reduced to zero in the calendar year after the participant's death, with the effect being that all remaining plan benefits would be required to be withdrawn within one year after the participant's death.

If the participant died before his or her required beginning date, and if the participant did not have a designated beneficiary as of his or her death, the beneficiary must withdraw the entire plan or account benefit within five years after the participant's death. Alternatively, if the participant did name a designated beneficiary, the plan balance may be withdrawn over the life expectancy of the designated beneficiary, so long as the withdrawals begin within one year of the participant's death. Therefore, where a noncomplying trust has been named as beneficiary the rate at which benefits

must be withdrawn may be greatly accelerated.

The difference in tax-deferral opportunities where a designated beneficiary has been named when contrasted with the withdrawal requirements where there is no designated beneficiary can be staggering. Therefore, when a trust is named as beneficiary, great care must be taken to ensure that the "look-through" rules apply, so that the beneficiary of the trust may be considered a designated beneficiary for purposes of required minimum distributions.

#### ***Loss of Maximum Benefit of Applicable Exclusion Amount by Allocating Plan Benefits to Credit Shelter Trust***

Because qualified plan benefits are income in respect of a decedent, they will be subject to income tax when withdrawn from the plan. Therefore, if a \$650,000 retirement plan is directed to a credit shelter trust as a means of utilizing the applicable exclusion amount, the amount net of income taxes that will pass to the ultimate beneficiaries will be substantially less than \$650,000 after the income taxes on distributions have been paid. If, instead, \$650,000 in cash on marketable securities were shielded from estate taxation through the applicable exclusion amount, the full \$650,000 could pass to the beneficiaries. For that reason, if one has other assets to direct to the credit shelter trust, that may be preferable to using retirement benefits.<sup>6</sup>

There may be situations, however, in which a client has insufficient nonretirement plan assets with which to fund a cred-

it shelter trust. In such a situation, a portion of the retirement benefits may need to be directed to such a trust. Because lifetime gifts and other dispositions at death may have used a part of the applicable exclusion amount, and further because the level of the applicable exclusion amount will vary between now and the year 2006, it is likely that a formula may need to be used to direct the appropriate amount of the retirement plan assets to the credit shelter trust, rather than an absolute dollar amount. For reasons that will be discussed more fully below, it may be preferable to include that formula in the retirement benefit beneficiary designation, rather than in the client's trust document itself, to direct the appropriate amount of retirement benefits to the credit shelter trust. The plan administrator, custodian, or trustee should be consulted about the acceptability of a formula in the beneficiary designation. The inclusion of language in the beneficiary designation that puts the burden of calculating the formula amount on the trustees of the recipient trust or upon the decedent's executor will render the formula designation much more likely to be acceptable to the administrator of the plan.

Another method for directing retirement plan assets to a credit shelter trust is by using a qualified disclaimer. Disclaimers of retirement plan benefits have been the subjects of favorable rulings.<sup>7</sup> The primary beneficiary designation could be the spouse, with the credit shelter trust as secondary beneficiary. Following the death of the plan owner, the

spouse could disclaim so much of the retirement benefits as were necessary to fully fund the credit shelter trust. Alternatively, the credit shelter trust could be named as the primary beneficiary, with the spouse as secondary beneficiary. In that case, the trustees would disclaim the excess of the plan benefits not sheltered from estate taxation by the applicable exclusion amount to the spouse outright.

#### ***Loss of Maximum Tax Deferral Opportunities from Naming a Marital Trust as the Beneficiary of Retirement Plan Benefits***

Even when the "look-through" rules are complied with so that the spouse who is the beneficiary of a marital trust is deemed the designated beneficiary for purposes of the minimum distribution rules, naming a marital trust as the beneficiary of retirement plan benefits may result in a loss of maximum income tax deferral opportunities for several reasons.

If a surviving spouse is named as the outright beneficiary of a retirement plan, that spouse has the option of rolling over the plan balance into an IRA in his or her own name.<sup>8</sup> The spouse can then defer distributions until the spouse reaches his or her required beginning date, which may permit a longer deferral opportunity than if the plan remained in the name of the participant. Further, having rolled over the participant's plan into his or her own IRA, the surviving spouse can then name his or her own designated beneficiary and use a joint life expectancy with a younger individual in cal-

culating required minimum distributions.<sup>9</sup> While there have been Private Letter Rulings that, in certain circumstances, have held that retirement plan benefits can be distributed from a trust to a surviving spouse to permit rollover, those rulings would likely not be extended to the ordinary qualified terminable interest property (QTIP) trust. Thus, when a QTIP trust is named as a beneficiary, the advantages of rollover to the spouse's IRA will likely not be available.

In addition, the requirements for qualifying retirement benefits for the estate tax marital deduction when the beneficiary of the plan is a marital trust (which will be discussed in detail in a future column) require that all the income on the undistributed portion of the plan from time to time (*i.e.*, the portion of the plan that is not distributed to the marital trust through required minimum distributions or otherwise) be distributed to the marital trust and from there to the surviving spouse each year.<sup>10</sup> The consequence of this requirement is that income in excess of the required minimum distribution may be required to be distributed, and hence subject to income tax, at a faster rate than if only required minimum distributions needed to be withdrawn from the plan.

#### ***Spousal Consent May Be Required***

The Retirement Equity Act of 1984 (REA) requires spousal consent for beneficiary designations for qualified plan benefits other than to a surviving spouse. This requirement does not apply

to IRAs or to certain profit-sharing plans. This spousal consent requirement adds another layer of administrative complexity to effecting a valid beneficiary designation to a trust, as there are numerous requirements governing how and when the spousal waiver is to be obtained.

### **The Requirement for “Looking Through” a Trust to Use the Trust Beneficiary as the Designated Beneficiary for Computing Required Minimum Distributions**

The requirements for “looking through” a trust for purposes of using the trust beneficiary as the designated beneficiary for computing required minimum distributions were recently changed by means of amendments to the Proposed Regulations to Section 401(a)(9)-1.<sup>11</sup> The current requirements are listed below.

#### ***The Trust Must Be Valid Under State Law***

The state in which the trust is established need to recognize that instrument as legally valid.

#### ***All Beneficiaries of the Trust Must Be Individuals***

This means that no corporations, estates, trusts, or charities can be beneficiaries of the trust. If a trust, for example, includes a \$10,000 legacy to a charity, with the remainder of the estate left to the spouse and children of the plan participant, all the beneficiaries of that trust are not individuals. Similarly, trusts that leave remainder interests to charity have been held to preclude the application of the look-through rules on the

ground that remainder beneficiaries must be considered in determining whether all beneficiaries are individuals.

#### ***All Beneficiaries Must Be Identifiable from the Trust Instrument as of the Required Beginning Date***

To comply with this requirement, all beneficiaries do not have to be identified by name, if by the applicable time (the required beginning date, in the case of a living participant, or the participant's earlier death) it is possible to ascertain which of the beneficiaries has the shortest life expectancy. Therefore, a description of beneficiaries by class (e.g., the “donor's children”) may be acceptable. Where there are several beneficiaries of a trust, the life expectancy of the oldest of the beneficiaries will be used in determining the required minimum distribution, and the proposed regulations require that there be an identifiable oldest beneficiary for this requirement to be satisfied.

Where a trust is named as a beneficiary of a retirement plan and the trustee has discretion to allocate trust property among subtrusts within that trust (such as a pourover trust in which a formula will divide trust property among a marital trust and a credit shelter trust, with the allocation between subtrusts to be made by the trustee), there may be some question as to whether it will be determined that the beneficiaries of the plan are identifiable. For that reason, a direction within the trust as to which subtrust retirement assets should be allocated may be

advisable. Alternatively, a formula for dividing retirement plan assets between a marital trust and a credit shelter trust may be included directly in the beneficiary designation to satisfy the “identifiability” requirement.

#### ***The Trust Must Be Irrevocable by Its Terms upon the Participant's Death***

This requirement was one of those changed by the recent amendment. Previously, the trust had to be irrevocable as of the required beginning date. The revised requirement that the trust be irrevocable by its terms upon the participant's death greatly simplifies estate planning for plan owners. Prior to the amendment, when a plan owner approached the required beginning date, a revocable trust that had previously been named as the beneficiary of the plan had to be made irrevocable—or, alternatively, a separate irrevocable trust had to be established and designated as the beneficiary—to permit the plan owner to use the life expectancy of a trust's beneficiary in determining the required minimum distribution.

Since the current requirement appears to require that the terms of the trust specify the trust's irrevocability after the death of the participant, it may be advisable to include a statement to that effect in the trust. Trustee amendment powers in trusts that give the trustees the ability to amend the trust after the death of the donor should be scrutinized to determine whether the retention of that power casts any doubt upon the irrevocability of the trust following the death of

the donor. The amendment does not provide guidance as to whether testamentary trusts created in wills will be deemed to become irrevocable by the terms of the will or the applicability of state law.

**Delivery of Documentation Regarding the Trust to the Plan Administrator Is Required**

In the case of a participant who dies before his or her required beginning date, by the end of the ninth month beginning after the death of the employee, the trustee of the trust must either (a) provide the plan administrator with a final list of all beneficiaries of the trust as of the date of death (including contingent beneficiaries and remaindermen, with a description of the circumstances under which such beneficiaries' interests will vest), with certification that the list is correct and complete and that the other requirements for "looking through" were satisfied as of the date of death, and with an agreement to provide a copy of the trust to the plan administrator upon demand, or (b) provide the plan administrator with a copy of the trust.

In the case of the death of a participant who is living as of his or her required beginning date, then *before* the required beginning date, the participant must either (a) provide the plan administrator with a copy of the trust and with any amendment thereto within a reasonable time of such amendment, or (b) provide the plan administrator with a list of all beneficiaries of the trust (including contingent beneficiaries and remaindermen, with a description of the circum-

stances under which such beneficiaries' interests will vest), with certification that the list is correct and complete and that the other requirements for "looking through" are satisfied. The participant must also agree to provide the plan administrator with a copy of the trust upon demand and with corrected certifications to the extent that amendments make changes to information included in previous certifications.

While providing the list of beneficiaries and certifications to the plan administrator preserves some degree of privacy for the participant (in that other provisions of the trust not relevant to the required information need not be disclosed), the burden on the person making the certification to accurately reflect the interests of all beneficiaries and to update certifications when necessary may make the provision of the trust document itself a more attractive option. It is possible that a plan administrator may require one or the other of the methods to be complied with, and it is therefore important to check with the administrator before complying with the disclosure requirements.

**Conclusion**

Naming a trust as the beneficiary of a retirement plan can accomplish a client's estate planning goals in a number of circumstances. The effect of this beneficiary designation may be, however, to lessen the potential benefits of income tax deferral or estate tax avoidance that would otherwise be available. Care must be taken when advising such a beneficiary designa-

tion and in complying with the numerous requirements that apply when a trust is to be the beneficiary of such assets.

**Endnotes**

1. FEDERAL ESTATE TAX EXEMPTION AMOUNT
 

<u>YEAR</u>	<u>AMOUNT EXEMPT</u>
1998	\$ 625,000
1999	\$ 650,000
2000	\$ 675,000
2001	\$ 675,000
2002	\$ 700,000
2003	\$ 700,000
2004	\$ 850,000
2005	\$ 950,000
2006 and beyond	\$1,000,000
2. Prop. Treas. Reg. § 1.401(a)(9)-1, D-2a, 52 Fed. Reg. 28070 (1987).
3. Prop. Treas. Reg. § 1.401(a)(9)-1, B-2, 52 Fed. Reg. 28070 (1987).
4. Prop. Treas. Reg. § 1.401(a)(9)-1, B-4, 52 Fed. Reg. 28070 (1987).
5. There are two permissible methods for calculating the life expectancy of the participant for purposes of the minimum distribution rules—recalculation and nonrecalculation [*see* Prop. Treas. Reg. § 1.401(a)(9)-1, E-6-8, 52 Fed. Reg. 28070 (1987)]. For a more detailed description of calculation methods, see this column in Volume 1 of ELDER'S ADVISOR J., p. 75.
6. In certain circumstances, the tax deferral opportunities presented by naming a grandchild or other young beneficiary as designated beneficiary of a retirement plan may

outweigh the income tax liability associated with the receipt of such asset and render the retirement plan a good candidate for the use of the applicable exclusion amount. Where a credit shelter trust is used and the spouse is to be a beneficiary, then even if the trust is eligible for "look-through" treatment, the life expectancy of the oldest beneficiary (likely to be the spouse) would be required to be used in computing the minimum required

distribution, thus not maximizing tax deferral benefits.

7. *See, e.g.*, Gen. Couns. Mem. 39,858 (Sept. 23, 1991); Priv. Ltr. Rul. 92-47-026 (Nov. 20, 1992).
8. Even where a spouse does not roll over plan benefits, where a plan owner dies before his or her required beginning date, the spouse can delay the commencement of minimum distributions until the participant would have attained age 70½ [I.R.C. § 401(a)(9)(B)(iv)].
9. There is a limitation on the deemed age of nonspouse beneficiaries known as the minimum incidental benefit rule, which will deem nonspouse beneficiaries to be no more than 10 years younger than the participant during the lifetime of the participant.
10. *See* Rev. Rul. 89-89, 1983-2 C.B. 41.
11. *See* Prop. Treas. Reg. § 1-401(a)(9)-1, D-5 and D-6, 62 Fed. Reg. 67780 (1997).