Marital Deduction Planning: Naming a Trust as Beneficiary of Retirement Plan Benefits

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Available at: http://scholarship.law.marquette.edu/elders/vol1/iss3/11

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Obtaining the estate tax marital deduction when a trust is named the beneficiary of retirement plan assets requires careful planning. Making a trust the beneficiary of retirement plan assets in order to serve as the vehicle for obtaining the estate tax marital deduction gives rise to a number of considerations.

By Barbara Freedman Wand

In my last column, I discussed the advantages and disadvantages of naming a trust as the beneficiary of a qualified retirement plan. I cautioned that qualifying a retirement plan asset for the estate tax marital deduction where a trust was designated as beneficiary took special care and would be addressed in a future column. Completing my trilogy of retirement plan columns, this column is devoted to marital deduction planning for retirement plan assets when a trust will be named as the beneficiary.

When a client wishes to use a trust for his or her spouse as the vehicle for obtaining the estate tax marital deduction, there may be a number of motivating factors. If the client's motive is simply to spare the spouse the burden of investment management, rather than to ensure that the remaining benefits at the death of the surviving spouse pass to the client's chosen beneficiaries, a number of trust options are available. One option is an estate trust, under which the remaining trust property at the death of the surviving spouse is payable to the estate of the surviving spouse. Another is a life income/general power of appointment trust, under which the surviving spouse must be entitled to all the income annually and be granted a testamentary general power of appointment over the trust property. Because the motive for utilizing a marital trust in many cases is the client's desire to control the disposition of the remaining trust property at the death of the surviving spouse, the most flexible and popular trust vehicle for qualifying trust assets for the marital deduction is the qualified terminable interest property trust, or QTIP trust. The QTIP trust does not require that the spouse be given any control over the disposition of the trust principal. Since the QTIP trust is the most commonly used marital trust in estate planning today, most guidance from the IRS on qualifying retirement benefits made payable to a trust for the marital deduction is issued in connection with QTIP trusts. This column focuses on qualifying a QTIP trust for the marital deduction when that trust is the...
designated beneficiary of retirement plan benefits.

**Spousal Consent to Trust as Beneficiary**

One threshold matter to discuss with any client considering naming a trust as the beneficiary of retirement benefits is the necessity for obtaining the spouse’s consent to such a beneficiary designation. Under the Retirement Equity Act of 1984, except in the case of individual retirement accounts and certain profit sharing and stock bonus plans, spousal consent is necessary if someone other than the spouse is to be named as the beneficiary of the plan or account. For some married couples, obtaining this consent will not be a problem. In other family situations, broaching the subject may be more problematic. The required consent must be in writing, either notarized or witnessed by a plan representative. The consent is limited to the particular alternative beneficiary designation consented to, unless by its specific terms the consent applies to future changes as well.

**Qualifying for the Marital Deduction**

Assuming that spousal consent can be obtained or is unnecessary, the task before the estate planner is to ensure that the designation of the trust as the beneficiary will qualify for the marital deduction (to the extent that the marital deduction is necessary for the proper operation of the estate plan in question). Before examining the special issues that must be addressed in qualifying a retirement benefit made payable to a trust for the estate tax marital deduction, let us review the basic rules for obtaining the marital deduction for a QTIP trust generally. These requirements are the backdrop against which the special issues for retirement benefits must be examined.

Section 2056 of the Internal Revenue Code (Code) and the Treasury regulations promulgated with respect to that section set forth the requirements for obtaining the marital deduction. The basic requirements for obtaining the estate tax marital deduction for property in a QTIP trust are as follows:

1. The property in the trust must pass from the decedent;
2. The spouse beneficiary must have a qualifying income interest for life; and
3. A QTIP election must be made on the decedent’s federal estate tax return electing to treat the trust property as QTIP property. The effect of this election is the inclusion of the QTIP property in the estate of the surviving spouse upon his or her death.

Where a client owns an interest in a retirement plan and names as the death beneficiary a trust that meets the other requirements of Code Section 2056(b)(7), the requirement of the property passing from the decedent will generally be satisfied. However, the latter two requirements demand special consideration when a trust is named as beneficiary: specifically, that the spouse receive a qualifying income interest for life and that the QTIP election be made on the decedent’s federal estate tax return electing to treat the trust property as QTIP property.

**Qualifying Income Interest for Life**

Code Section 2056 provides that a surviving spouse has a qualifying income interest in property for purposes of the marital deduction if the spouse is entitled to all the income from the property, payable annually or more frequently for life, and no person has a power to appoint any part of the property to any person other than the spouse during the spouse’s lifetime.

Satisfying the requirement that the surviving spouse receive all the income from the trust at least annually is a relatively simple requirement to fulfill when the QTIP property is held entirely within the QTIP trust and the income that is earned by the trust can be passed through to the spouse. Special challenges arise when the QTIP property consists of retirement benefits of which the trust is named as the beneficiary. For so long as the benefits remain within the qualified plan, they can grow tax deferred. Depending upon the needs of the spouse, the optimal strategy from an investment perspective may be to allow the benefits to remain in the plan tax deferred as long as possible. Minimum distribution rules may not require that any distributions be taken from the plan for many years (until the deceased plan owner would have attained age 70 1/2). In such a case, any income earned on the retirement plan benefits for which a QTIP election was made would remain in the plan, not passing to the QTIP trust, nor to the spouse.
Even when minimum distribution rules require that some distribution be taken from the plan, it is possible that the required minimum distribution might be less than all the annual income earned on the plan, depending upon the applicable life expectancies upon which the required minimum distribution is calculated and the level of the income being earned within the plan.

The retention in the plan of all or some of the annual income earned on it is problematic if a QTIP trust has been named as the designated beneficiary of the plan and the marital deduction is sought. The IRS has held that when income is retained in the retirement plan, the QTIP requirement that the spouse is entitled to all the income from the property has not been satisfied. In Revenue Ruling 89-89, the IRS held that in order for plan benefits to qualify for QTIP treatment, the spouse must actually receive all the income earned by the plan annually. Achieving this goal will require coordinating the client's beneficiary designation and the terms of the QTIP trust to ensure that the spouse will actually receive all the annual income earned in the plan.

Before focusing on the specific method of complying with the requirements of Revenue Ruling 89-89, it is not unreasonable to pause to challenge the logic behind the IRS ruling. After all, Code Section 2056 by its terms requires only that the spouse be “entitled” to receive all the income on the QTIP property, not that the spouse actually receive it. In Treasury regulations interpreting the “entitlement” to income requirement of life income/power of appointment trusts, the IRS has not required that annual income actually be received by the spouse so long as the spouse has the real power to demand the payment of the income at least annually and so long as the trust property is either productive or subject to being made productive at the demand of the spouse.

In Revenue Ruling 89-89, however, the IRS did not adopt a similar approach. For QTIP treatment to be available for the plan benefits, the provisions of the beneficiary designation, the form of payment provisions of the plan, and the terms of the QTIP trust, when viewed together, must result in all the income from the plan actually being distributed from the plan to the QTIP trust and then being distributed from the QTIP trust to the spouse. Further, the ruling made it clear that for QTIP treatment to be obtained, these requirements must be met as of the death of the plan owner. Therefore, the QTIP marital deduction for the plan benefits will not be allowed if: (1) the trustee of the QTIP trust, as the designated beneficiary of the qualified plan, has the option of choosing a form of payment that would not result in withdrawal of all of the income from the plan each year, or (2) the form of benefit chosen by the plan owner before his or her death or the forms of benefit available from the plan do not allow the withdrawal of all the income from the plan on an annual basis.

For these reasons, it is extremely important to examine the plan documents when a client wishes to name a trust as the beneficiary of a qualified plan, to determine whether the plan has the flexibility to permit the payment provisions that the IRS deems necessary for QTIP treatment. The plan must be administered in such a way as to permit ascertaining the annual income earned on the plan benefits. The form of benefits that are available from the plan must also permit the withdrawal of the annual income earned on the plan benefits. In addition, no irrevocable form of benefit must be in place that is inconsistent with the annual withdrawal of income from the plan.

Assuming that the terms of the plan will permit the annual income to be withdrawn, the client's beneficiary designation, the choice of form of benefits, and the terms of the QTIP trust must be coordinated to ensure that these documents, when read together, will support QTIP treatment. Using Revenue Ruling 89-89 as a road map for obtaining the marital deduction, the following provisions should be put into place:

1. The beneficiary designation should name the trust as the beneficiary of the plan benefits (spousal consent requirements must, as noted above, be complied with before this step can be taken).
2. The form of benefit provisions of the beneficiary designation should require that the annual distribution from the plan be the greater of all of the annual income earned on the plan or the required minimum distribution under Code Section 401(a)(9).
3. The terms of the plan and the form of benefit provi-
sions should permit the trustee to withdraw amounts larger than any required minimum distribution or income from the plan. (This flexibility is important to permit the trustee to convert unproductive property in the plan to productive property by withdrawing the plan benefits and reinvesting them within the QTIP trust.)

4. The QTIP trust should require the trustee to select a payment option for any plan benefits that are QTIP property that requires an annual distribution of the greater of all of the annual income earned on the plan or the required minimum distribution under Code Section 401(a)(9).

5. The QTIP trust should require that to the extent that annual distributions from the plan represent income earned on the plan, income be paid from the QTIP trust to the spouse. (It appears that the portion of any required minimum distribution or larger distribution that is in excess of the annual income earned on the plan may be allocated to principal and not distributed to the spouse, even though the entire distribution is characterized as income for income tax purposes.)

6. The QTIP trust should provide that the income on any portion of the plan that is properly allocated to principal be paid to the spouse at least annually.

7. The QTIP trust should provide that the spouse has the right to demand that any nonproductive property held in the QTIP trust be made productive.

8. The QTIP trust should give the trustee the right to distribute to the spouse from other trust property the income that would have been earned had nonproductive property been productive and to distribute from other trust property an amount equal to the income earned on any undistributed plan benefits where the income cannot or has not been withdrawn from the plan.

9. The QTIP trust should provide that required income distributions shall not be subject to reduction by reason of any expenses allocable to trust principal.

10. General provisions regarding construction of the provisions of the QTIP trust should make clear that it is the intention of the donor that all plan benefits made payable to the QTIP trust qualify for the marital deduction, and hence all powers and discretion of the trustees be exercised or exercisable only in a manner consistent with that intention and all questions regarding construction of the trust be resolved accordingly.

Electing QTIP Treatment for Qualified Retirement Plan Benefits

Revenue Ruling 89-89 also provides guidance on the appropriate method for satisfying the requirement that a QTIP election be made on the decedent’s federal estate tax return electing to treat the trust property as QTIP property. Ordinarily, one would elect QTIP treatment for an entire trust rather than for specific assets held within the trust. When QTIP treatment is sought for a retirement plan of which the QTIP trust is designated as beneficiary, it appears that a QTIP election must be made both for the QTIP trust and for the retirement plan asset itself. This added requirement may be necessary because a portion of the asset for which QTIP treatment is sought, namely, the undistributed portion of the plan, “resides” outside of the trust.

Non-U.S.-Citizen Spouses and the Marital Deduction for Retirement Plan Benefits

Where the surviving spouse is a non-U.S. citizen, marital deduction rules differ substantially from those applicable to citizen spouses. The marital deduction for a non-U.S.-citizen spouse generally depends upon the deposit of the decedent’s assets in a qualified domestic trust (QDOT), either by terms of the decedent’s estate plan or by the surviving spouse after the decedent’s death. However, the anti-alienation provisions applicable to qualified plan assets may prohibit a surviving spouse from transferring a qualified plan benefit to a QDOT if the decedent has failed to directly name the QDOT as the designated beneficiary. In this situation, alternative avenues have been established to permit the plan benefits to qualify for the marital deduction. In this case, the marital deduction is available if the sur-
viving spouse either agrees to roll over the corpus portion of distributions from the plan to a QDOT as they are received or agrees to pay the estate tax on the corpus portion of distributions as they are received. The lesser benefits of the marital deduction for non-U.S. citizen spouses are considerable and beyond the scope of this column, but must be noted in any discussion of the marital deduction.

Planning Considerations
As is evident from the IRS position on obtaining the marital deduction for qualified retirement plan benefits made payable to a trust, the cost of using a trust as the designated beneficiary has significantly lessened opportunities for continued income tax deferral. QTIP treatment can only be achieved when all the income is withdrawn from the plan and distributed to the spouse on an annual basis. This requirement may result in distributions being made from the plan significantly in advance of the time when required minimum distributions would otherwise have to be made. Any client considering naming a trust as the beneficiary of retirement plan benefits should understand the costs and benefits of this approach and make a reasoned decision based upon all the circumstances.

Conclusion
When a client has determined that his or her estate planning goals can best be met by naming a trust as the beneficiary of qualified retirement plan benefits for the benefit of the surviving spouse, great care must be taken to ensure that the marital deduction is available for the retirement plan asset. Reviewing the provisions of the plan in question, the beneficiary designation, and the form of benefits available and in place, and crafting the terms of the beneficiary designation and marital trust are necessary tasks in achieving the client’s goals. Full consideration of the impact of this approach on the continued growth of the plan assets must be undertaken so that the client makes an informed decision on how to proceed.

Endnotes
1. For purposes of this article, the terms “retirement plan benefits” and “qualified retirement plan” include individual retirement accounts (IRAs).
3. Where a client wishes the remaining trust assets at the death of the surviving spouse to pass to a charity, a charitable remainder trust for the life of the surviving spouse can provide the marital deduction at the client’s death, control by the client over disposition of the trust property upon the spouse’s death, and an estate tax charitable deduction for the remainder interest as well.
6. See id.
11. The marital deduction available in the case of a non-U.S.-citizen spouse differs markedly from the ordinary marital deduction, with any principal distributions to the surviving spouse being taxed at the time of distribution at the rate of the decedent. See I.R.C. § 2056A.