

PLR 200438044 – “See-through” Trusts Illustrated

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"The decision about whether to allocate the retirement account to fund the Marital or Bypass trusts can now be made on a post-mortem basis!"

The use of trusts as a retirement account beneficiary is becoming increasingly familiar, feasible, and practical as a planning tool.

Michael E. Kitces, Director of Financial Planning for **Pinnacle Advisory Group, Inc.**, a private wealth management firm located in Columbia, Maryland, shares his thoughts about PLR 200438044 which together with final regulations for IRC Section 401(a)(9) issued in 2002, illustrate and expand as well as simplify the ability to use “see-through” trusts. Michael also points out the cons as well as the pros of this technique.

EXECUTIVE SUMMARY:

PLR 200438044 ruled that a retirement plan's trust beneficiary qualified as a “see-through” trust within the meaning of Treasury Regulation 1.401(a)(9)-4, and that post-death required minimum distributions will be based on the life expectancy of the trust's oldest beneficiary.

FACTS:

BACKGROUND:

A deceased taxpayer had named his Revocable Living Trust (a valid trust under state law) as the beneficiary of his company retirement plan.

At the death of taxpayer in 2003, the trust split into two separate sub-trusts administered by a third-party trustee, creating a QTIP-style Marital trust and a Bypass trust.

A fractional allocation formula was used to transfer enough property to the Marital trust to eliminate estate taxes. The trust became irrevocable at the taxpayer's death.

Documentation of the trust was provided to the company plan administrator in a timely fashion (by October 31st, 2004) after taxpayer's death.

Both sub-trusts provided for all income to be paid to the surviving spouse, and allowed discretionary distributions of principal from a third-party Trustee for the surviving spouse's welfare.

Both sub-trusts allowed the surviving spouse to appoint the trust property at her death to any of the taxpayer's lineal descendants or their spouses.

The surviving Spouse disclaimed her limited power of attorney to appoint property at her death under a qualified disclaimer. As a result of this disclaimer, the property of both trusts will be divided among and held in separate trusts for the taxpayer's lineal descendants at the second death.

Property left to lineal descendants is to be held in trust until age 30. However, each of taxpayer's children had already attained age 30 prior to the death of taxpayer.

ISSUES

Three issues were submitted for consideration in the letter to the IRS:

- (1) Is the trust beneficiary a qualified "see-through" trust within the guidelines of Treasury Regulation 1.401(a)(9)-4?
- (2) If the surviving spouse is still living on September 30th, 2004, can required minimum distributions from the retirement plan be calculated based upon her life expectancy?
- (3) Are the required minimum distribution calculations still the same if the surviving spouse dies prior to September 30th, 2004?

COMMENTS:

WHAT'S A "SEE-THROUGH" TRUST?

Treasury Regulation 1.401(a)(9)-4, Q&A-5 provides that beneficiaries of a trust may be treated as designated beneficiaries if the following requirements are met:

- (a) The trust is valid under state law, or would be but for the fact that there is no corpus.
- (b) The trust is irrevocable, or the trust contains language to the effect it becomes irrevocable upon the death of the employee.
- (c) The beneficiaries of the trust (who are beneficiaries with respect to the trust's interest in the employee's benefit) are identifiable as a designated beneficiary from the trust instrument.
- (d) The plan administrator must receive a copy of the actual trust document that is named as beneficiary of the plan by October 31st of the calendar year following the year of death (or alternatively, the trustee can provide the plan administrator with a final list of all trust beneficiaries as of September 30th of the year following the year of death,

certify that all other conditions are met, and agree to provide a copy of the trust instrument upon demand).

Decedent's representative asserted that conditions (a) and (b) were satisfied by the valid nature of the trust itself and its terms under state law, and that condition (d) had been completed within the prescribed time limits.

In addition, review of the terms of the trust allow the determination of the identity of each person entitled to receive a benefit from the trust (since each of taxpayer's children was already over the age of 30 as of the death of the taxpayer, and the spouse disclaimed her limited power to alter the apportionment of the trust account at her death, each of taxpayer's individual children had his/her own unrestricted right to a portion of the remainder interest). Each of these individuals separately satisfies the definition of a "designated beneficiary" under Q&A-1 of Treasury Regulation 1.401(a)(9)-4.

Because all of the required terms were met, the Service ruled that the trust did in fact constitute a qualified "see-through" trust.

SO WHOSE LIFE (EXPECTANCY) IS IT, ANYWAY?

The second question posed in the PLR was whether required minimum distributions could in fact be determined based upon the surviving spouse's life expectancy (in her role as a beneficiary of the trust) if she was still alive on September 30th, 2004 (the beneficiary designation date).

An ancillary question posed was whether those required minimum distributions would still be determined over the spouse's life expectancy if she passed away before September 30th, 2004.

Since the trust met the "see-through" requirements of Treasury Regulation 1.401(a)(9)-4, the beneficiaries of the trust may be used to determine the applicable distribution period for required minimum distributions.

The beneficiaries of the trust for purposes of required minimum distributions included the spouse (who was entitled to income and principal, subject to a standard, from each of the sub-trusts), and the children (who had an unrestricted right to a remainder interest of the trust as of the taxpayer's death). It is notable here that the Service, consistent with Treasury Regulation 1.401(a)(9)-4, Q&A-1, views the children as designated beneficiaries, even though their beneficial interest was a future interest (delayed until the death of the surviving spouse) and not a current one (and, as such, not a contingent interest).

Under IRC Section 401(a)(9)(B)(iii), distributions from a retirement plan may be extended over the lifetime of the designated beneficiary.

Treasury Regulation 1.401(a)(9)-5 prescribes that when more than one individual is a designated beneficiary, the individual with the shortest life expectancy will be the designated beneficiary for purposes of determining the applicable distribution period.

Since all four individuals are considered designated beneficiaries (“seeing through” the trust) under Treasury Regulation 1.401(a)(9)-4, and there were no non-designated beneficiaries, the retirement plan distributes its assets over the life expectancy of the surviving spouse (the oldest beneficiary with the shortest life expectancy) affirming the second part of the Private Letter Ruling inquiry.

Given that the spouse’s life expectancy is to be used because she is the designated beneficiary for purposes of determining the applicable distribution period, Treasury Regulation 1.401(a)(9)-4, Q&A-4(c) explicitly states that if such a beneficiary (who was a beneficiary as of the taxpayer’s death) dies prior to September 30th of the year following the year of death without disclaiming, that she will continue to be treated as beneficiary for purposes of required minimum distributions without regard to any successor beneficiaries. This resolved the third question posed in the Private Letter Ruling inquiry.

SEEMS STRAIGHTFORWARD. SO WHAT'S THE BIG DEAL HERE?

At first look and face value, this Private Letter Ruling is in fact quite straightforward. The decedent taxpayer’s representative followed all of the necessary (and fairly simple) steps to ensure that the trust was treated as a “see-through” trust, and the shortest life expectancy of the designated beneficiaries was used.

The notable thing about this letter ruling is what it actually accomplished, because it has very widespread potential application.

This letter ruling approved a revocable living trust that separated into A/B (Marital/Bypass) sub-trusts at the death of the grantor, as a “see-through” trust to allow the trust beneficiaries to stretch required minimum distributions over the lifetime of the oldest beneficiary.

This is notable – not only because the retirement plan may be used to fund the Bypass trust (when other assets may not be available) – but more importantly, the decision about whether to allocate the retirement account to fund the Marital or Bypass trusts can be made on a post-mortem basis!

This is distinctly different than when a revocable trust is not used. If the A/B trusts are testamentary trusts created by Will, and the retirement plan were to have the estate

indicated as a beneficiary, the estate cannot currently direct the retirement plan to one of the testamentary trusts or the other on a post-mortem basis and allow for life-expectancy-based distributions.

Instead, the estate is treated as a non-designated beneficiary (there is nothing in the Regulations about a “see-through estate”, and beneficiaries indicated by Will are specifically not designated beneficiaries under Treasury Regulation 1.401(a)(9)-4, Q&A-1), requiring either the 5-year-rule (if death occurred before the required beginning date), or payout over the decedent’s remaining actuarial life expectancy (if death occurred on or after the required beginning date) for post-death distributions.

So the revocable living trust scores a big win over Wills for post-mortem planning with retirement plans!

ANY DRAWBACKS TO THIS METHOD?

The most notable disadvantage to this method (naming the revocable trust as beneficiary of the retirement plan) is that the spouse cannot complete a rollover of the retirement plan account to her own IRA, and allowing a subsequent “stretch” of the IRA after her second death.

If the spouse is young, this may be a substantial disadvantage there may have been decades before the spouse would have otherwise been required to take distributions at her age 70 ½, and even after that point the distributions would have been “reset” to the life expectancy of her beneficiaries at her death.

Thus, while this planning opportunity to make a post-mortem determination about which trust the retirement plan will fund is nice, it may not be so beneficial for younger couples.

On the other hand, this can generally be solved by simply naming the surviving spouse as primary beneficiary (unless it’s important to leave the non-Bypass property to the spouse in a QTIP-style trust for other planning reasons), and the revocable trust as a contingent beneficiary.

Just be certain that you’re prepared to have the surviving spouse execute a post-mortem qualified disclaimer. By this route, though, one could also simply name the Bypass trust directly as the contingent beneficiary.

ARE THERE PITFALLS OR TAX TRAPS TO THIS STRATEGY?

One of the most important pitfalls to the strategy is the need to satisfy all of the requirements necessary to stretch required minimum distributions of the life expectancy of the beneficiaries. The critical element here is satisfying the “see-through”

trust requirement that all of the beneficiaries be “identifiable” as designated beneficiaries.

Treasury Regulation 1.401(a)(9)-4, Q&A-1 specifies that a designated beneficiary is an individual who is designated as a beneficiary under the retirement plan. In addition, although a designated beneficiary does not need to be specified by name, the individual does need to be identifiable. If the beneficiary designation indicates a class of beneficiaries capable of expansion or contraction, it must be possible to identify the class member with the shortest life expectancy.

Thus, when planning to use a “see-through” trust, it is critical to ensure that the beneficiaries will be identifiable under the guidelines otherwise, the “see-through” benefits (stretching distributions over the life expectancy of a beneficiary) are not allowed.

ANY OTHER POTENTIAL PROBLEMS?

The other major pitfall to be aware of, which didn’t occur in this case but could have, is that not all employer retirement plans allow life-expectancy-based distributions to non-spousal beneficiaries.

Also, although tax law allows such distributions, not all plan documents do (for the fairly obvious reason that the employer doesn’t want to administer your account for the benefit of your non-spousal beneficiaries for the next several decades).

Consequently, it is often best to rollover the employer retirement plan to an individual IRA, and proceed with the trust-beneficiary-planning from there. Virtually all IRA Custodian Agreements do allow all of the distribution options allowed by the Service.

Lastly, if the retirement plan distributions are going to be accumulated within the trust, be prepared to pay high income taxes since trusts are into the highest tax bracket at around \$10,000 of net income.

THE BOTTOM LINE:

In combination with other recent PLRs, use of trusts as a retirement account beneficiary is becoming increasingly feasible and practical as a planning tool without (too) adverse tax consequences. In addition, thanks to the final regulations for IRC Section 401(a)(9) issued in 2002, the ability to use “see-through” trusts has been greatly broadened and simplified.

Use of “see-through” trusts, when it is necessary to use a trust as a beneficiary of a retirement account (whether to fund a Bypass trust or for other reasons) will allow for a

“stretch” of distributions over the life expectancy of the oldest beneficiary, as long as you follow the fairly straightforward rules of Treasury Regulation 1.401(a)(9)-4.

TECHNICAL EDITOR’S COMMENT:

When it comes to retirement plan beneficiaries, sometimes the KISS (Keep It Simple Stupid!) method is the best method.

Before naming a trust as beneficiary, make sure that the trust is in fact needed. In this PLR, the trust served a very important use. But in too many cases, the trust provides no advantages and ends up resulting in disadvantages in addition to the added expense and complexity associated with trusts as beneficiaries.

HOPE THIS HELPS YOU HELP OTHERS!

Michael Kitces

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