Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE – H.R. 1994)

(AS PASSED BY THE HOUSE IN MAY, 2019)

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Elimination of the Stretch IRA (or Other Retirement Account) for Non-spouse Beneficiaries

Elimination of the stretch IRA for non-spouse beneficiaries has been on and off the table in one form or another since 2012, if not earlier. In 2016, the Retirement Enhancement Saving Act was voted out of the Senate Finance Committee 26-0. However, it died with the 114th Congress at the end of 2016. The ACTEC Employee Benefits Committee formed a task force to give comments to the Joint Committee on Taxation about RESA because it was administratively unworkable.

RESA reemerged in 2018 in the House and Senate, and again in 2019 in the House. The Senate also introduced RESA in 2019 but in a different form from the previous version. Both RESA and SECURE are omnibus bills affecting retirement plans. The elimination of the stretch for non-spouse designated beneficiaries appear at the end of each bill. RESA would raise revenue generally by using the 5-year rule instead of the stretch, subject to each non-spouse designated beneficiary being allowed to use the current stretch rules for the first $400,000 of inherited retirement benefits from an account owner. SECURE uses a 10-year rule for non-spouse designated beneficiaries. Both proposals have identical exceptions for certain beneficiaries. On May 23, 2019, the House passed the SECURE bill by a margin of 417-3 (11 not voting). Because of the simplicity of administration of the elimination of the stretch under SECURE, it is the retirement bill that is more likely to pass, although RESA was a more complete retirement reform package.

The House version was delivered to the Senate but met resistance from a group of senators because the House added a last-minute change to 529 plans to eliminate a provision for home-schooling expenses, a non-retirement issue. As of this writing, it is still being held up because of the home-schooling objections and the bill has not been formally introduced in the Senate. It is not clear that it will pass in the Senate for procedural reasons, and, therefore, whether it will pass at all in 2019.

I. **The House 2019 SECURE Bill.** Section 401 of SECURE would make a new 10-year rule applicable to most non-spouse beneficiaries for an account owner's *defined contribution* retirement accounts, i.e., IRAs, Roth IRAs, 401(k) and 403(b) plans.

   A. The SECURE bill applies to all non-spouse *designated* beneficiaries except for eligible designated beneficiaries.

   B. SECURE creates three classes of beneficiaries:

      i) Designated beneficiaries;

      ii) Eligible designated beneficiaries; and

      iii) A beneficiary that is neither class of -designated beneficiaries.

C. If the non-spouse beneficiary is "merely" a "designated beneficiary," then the 10-year rule will apply.

   i) The account owner's required beginning date is no longer relevant for determining the applicable distribution period for a non-spouse designated beneficiary.

   ii) Presumably, the 10-year rule will be applied in the same manner as the 5-year rule; the inherited retirement account must be liquidated by December 31 of the year in which the 10^{th} anniversary of the account owner's death occurs.

D. If the non-spouse beneficiary is not a designated beneficiary, such as a charity or the account owner's estate, the rules are unchanged for non-designated beneficiaries.

   i) If the account owner dies before his or her required beginning date the 5-year rule still applies.

   ii) If the account owner dies on or after his or her required beginning date, then the non-designated beneficiary uses the account owner's theoretical life expectancy to determine required minimum distributions.

   iii) This appears to be a drafting anomaly.

      (1) If an account owner dies between the ages of 70 and 78, the non-designated beneficiary would use an applicable distribution period of more than 10 years

      (2) The IRS table would suggest this is true for age 79, but the applicable distribution period for the beneficiary would be determined by the account owner's age in the year of death reduced by a factor of 1 for the following year, which is the year of the non-designated beneficiary's first required minimum distribution.

E. There are exceptions for "eligible designated beneficiaries" who are:

   i) The surviving spouse who receives an inherited IRA or retirement account or completes a rollover;

   ii) Disabled individuals as defined in IRC 72(m)(7);

   iii) Chronically ill individuals as defined in IRC 7702B(c)(2). The individual's illness must be certified to be indefinite and reasonably expected to be lengthy;

   iv) Children of the account owner who have not reached the age of majority; and

   v) Individual beneficiaries who are not more than ten years younger than the account owner.

   The determination of eligible designated beneficiary status is made as of the date of death of the account owner.

F. The eligible designated beneficiaries generally use the current stretch rules.

i) A surviving spouse can still roll over to his or her own IRA or other plan. The surviving spouse can also use the current inherited IRA rules.

(1) Presumably, the SECURE rules, including the stretch for the eligible designated beneficiaries, will apply to the spouse's beneficiaries following the rollover to the spouse's IRA or other retirement account.

(2) It is less clear whether the rules for eligible designated beneficiaries will apply following the establishment of an inherited IRA or other inherited retirement account by the surviving spouse, i.e., an account that still has the account owner's name in the account caption.

ii) Minors may be able to use the current rules to stretch the inherited IRA (or retirement account) until age 36 in some cases.

(1) A minor child is defined in the current required minimum distribution Treasury regulation §1.401(a)(9)-6, A-15 governing payments from a defined benefit plan or annuity contract to a surviving child.

(a) "…(A) child may be treated as having not reached the age of majority if the child has not completed a specified course of education and is under the age of 26."

(b) "A specified course of education" is not further defined in the regulation.

(2) Once the child attains the age of majority, if the child is not also disabled, the 10-year rule applies.

(3) Therefore, it is possible that a well-educated child may defer the complete liquidation of the inherited retirement account until age 36.

(4) This assumes that this defined benefit plan regulation will apply to defined contribution plans under SECURE.

iii) A successor beneficiary who takes at the death of an eligible designated beneficiary uses the 10-year rule for all distributions from the inherited IRA or other retirement account.

G. Other notable changes in the SECURE Act:

i) The required beginning date is raised to age 72.

ii) Traditional IRA contributions will no longer be limited to the years prior to the year of the IRA owner attains age 70½, just as they are currently not restricted by age for Roth IRA contributions.

iii) Annuities may be offered by employers with less liability to employers. This provision was pushed by the insurance industry and may not be as consumer friendly as it looks.

iv) Expansion of qualified higher education expenses in 529 plans, although homeschooling expenses were eliminated at the last minute.

v) Repeal of the current Kiddie Tax rules. The law would revert to the pre-TCJA of 2017 rates. This was also a very late addition to the Act.

H. **Effective Date.** The SECURE effective dates are generally for decedents dying after December 31, 2019.

(1) Therefore, the designated beneficiaries of a decedent dying before or during 2019, including see-through trusts, will use the life expectancy method to determine the applicable distribution period for required minimum distributions for their inherited IRAs or other retirement accounts.

(2) However, their successor beneficiaries will use the 10-year- rule for the distributions after the initial beneficiary's death. Successor beneficiaries will not be allowed to continue using the remainder of the original applicable distribution period, unless presumably, the remaining payout period using the original applicable distribution period is less than the 10-year rule.

(3) Special effective dates apply to collectively bargained plans and governmental plans.

(4) SECURE does not apply to certain annuities which are binding and are irrevocably in pay status or for which the account owner has made an irrevocable election as to the method or amount of annuity payments to the account owner or to designated beneficiaries.

I. **ACTEC Comments.** The American College of Trust and Estate Counsel has submitted comments to various members of the House and Senate on the original RESA bills. To read the ACTEC comments, go to www.actec.org, look under the "Resources" tab, and click on "Government Submissions." Although many of the comments regarding the administrative issues that the task force found troubling are not relevant to SECURE, many of the other issues, especially those pertaining to trusts, still apply.

II. Trusts under the SECURE Act. The current Treasury regulations governing trusts as beneficiaries of retirement accounts do not match up well with the SECURE distribution scheme for non-spouse designated beneficiaries and most non-spouse eligible designated beneficiaries who might receive their inherited retirement benefits in trust.

A. **See-Through Trust Regulations.** Presumably, the see-through trust regulations will still apply under these laws in some fashion to allow, for example, a special needs trust beneficiary of a see-through trust to be treated as an eligible designated beneficiary. A more complete overview of the current rules for trusts, including more detail on see-through trusts, accumulation and conduit trusts follows in Section III.

B. **Problems with the Current See-through Trust Regulations and SECURE.** The focus of the current see-through trust regulations is to identify the pool of beneficiaries who might receive an interest in the retirement account payable to the trust through the trust termination.

i) More specifically, the process requires the identification of those beneficiaries that may ultimately receive an interest in the retirement account, and, specifically, the beneficiary or beneficiaries who will finally receive the retirement account outright. (An accumulation trust)

ii) However, it appears that the focus of the drafters of the SECURE statute is the identity of the beneficiary who will receive the retirement benefits immediately at the death of the account owner. The classification of individual beneficiaries as either "designated beneficiaries" or "eligible designated beneficiaries" demonstrates this mindset.

iii) Alternatively, the trust may be drafted so that all withdrawals from a retirement account payable to a trust, whether a required minimum distribution or an additional withdrawal, must be distributed to the trust beneficiary within the calendar year of the withdrawal. (A conduit trust). Conduit trusts have their own issues under SECURE.

iv) It is important to remember that much of the structure for the trust rules come from the Treasury regulations as supplemented by private letter rulings, not the Code. The current IRC 401(a)(9) does not mention trusts as beneficiaries of retirement accounts.

C. **The "merely" designated beneficiaries under SECURE receiving their benefits through a trust will not work well within the current see-through trust regulations.**

i) The accumulation trust requirement to determine who will take outright at the death of the current beneficiary of the retirement benefits should become irrelevant.

(1) Under current trust regulations, the remainder beneficiary's identity helps to determine whether the trust is a see-through trust as well as the applicable distribution period for required minimum distributions

(a) If the primary trust beneficiary or beneficiaries are individuals, their applicable distribution period should be the 10-year period.

(b) The IRS should no longer care that a charity might receive a portion of the retirement account if the primary beneficiary happens to die within the 10-year period. This is a "gotcha" under the current law that should go away, given the short time period that designated beneficiaries , who must be individuals. will use to receive their benefits.

(c) Of course, with the drafting anomaly in the statute, that allows a non-designated beneficiary to use the account owner's remaining life expectancy to determine the applicable distribution period under both the current rules and SECURE, it may be beneficial if the trust is not a see-through trust if the account owner dies after his or her required beginning date and is younger than age 78 because the applicable distribution period will be longer than 10 years.

(2) The IRS should no longer care whether the remainder beneficiary is a charity or an individual. Designated beneficiaries will be required to take their benefits over a 10-year period.

(3) This issue becomes more acute in the context of eligible designated beneficiaries discussed below.

(4) The one improvement that will occur with SECURE is that if a trust is named as the beneficiary and the retirement accounts payable to the trust are required to be distributed outright to designated under SECURE, all of these trust beneficiaries will be treated in the same manner as if they had been named directly in the beneficiary designation form; they will use the 10-year rule.

(a) This would be a simplification.

(b) Under current law, the trust beneficiaries would have to take their required minimum distributions based on the life expectancy of the oldest trust beneficiary.

(i) In contrast, if the same beneficiaries were named directly in the beneficiary designation, each beneficiary could use his or her own life expectancy to determine the applicable distribution period for required minimum distributions. (The separate account rule of Treasury Regulation §1.401(a)(9)-4, A-5(c).)

(ii) It is unclear what would occur if an eligible designated beneficiary other than the surviving spouse is in the mix of beneficiaries, e.g. a beneficiary who is not more than 10 years younger than the account owner.

ii) The 10-year rule may not work well with a conduit trust. If a trust is designed to distribute only required minimum distributions through a conduit trust, and allows no additional distributions, there will be no distributions until the tenth year of the trust. In that year, the required minimum distribution will be the entire balance of the retirement account.

(1) For a Roth IRA:

(a) A conduit trust may be an “optimal” result, under SECURE, if the beneficiary’s situation is such that future taxable earnings would be better taxed to the beneficiary individually, especially if the trust is not economical.

(b) An accumulation trust may be a better choice where it can grow tax-free within the IRA for 10 years and the trustee has discretion to control distributions after the tenth year. The Roth distribution will continue to have protection from creditors within the accumulation trust.

(2) On the other hand, if the goal is to distribute a traditional retirement account fairly evenly over the 10-year period, then perhaps a conduit trust will work well to take advantage of the beneficiary's lower income tax rate.

(a) However, the conduit trust must be designed to allow the trustee discretion to take withdrawals without being limited by an ascertainable standard in many instances so that the distributions can be "amortized" over the ten-year payout period.

(b) The conduit trust does not provide asset protection for more than the initial 10-year period.

(3) By giving a trustee discretion to determine year by year (through year 9) how much to withdraw from the IRA or other retirement account payable to the trust, the trustee can look at the beneficiary's projected tax picture each year and make withdrawals and mandatory distributions (or use the withdrawals for the benefit of the beneficiary). It will require a very engaged and sophisticated trustee.

(4) The repeal of the TCJA version of the Kiddie Tax in SECURE will come as welcome relief for those beneficiaries who are subject to the Kiddie Tax and are not eligible designated beneficiaries, such as the account owner's grandchildren. For them, a conduit trust with broad discretionary powers may work well.

iii) SECURE will hit hard those families with children who have problems, such as those in bad marriages, those who are mentally ill but refuse treatment who will not be classified as disabled or chronically ill, beneficiaries in high-risk professions, and spendthrift children.

D. **Eligible Designated Beneficiaries Taking in Trust under SECURE.** The eligible designated beneficiaries will still be able to use the stretch under SECURE, or will they?

i) Most eligible designated beneficiaries will receive their retirement benefits in trust. Those that won't are the surviving spouse and probably most of the beneficiaries who are not more than 10 years younger than the account owner.

ii) The eligible designated beneficiaries who will take their shares in trust are those who are the most vulnerable; the disabled, chronically ill, and minor children of the account owner.

iii) If the disabled and chronically ill beneficiaries are not wealthy and may need means-tested government benefits, they will use a discretionary accumulation trust.

(1) The tax burden will not change for these eligible designated beneficiaries because the trustee will be able to take required minimum distributions using the life expectancy method.

(2) However, the current see-through trust regime should no longer be relevant. At the death of the eligible designated beneficiary, the individual remainder beneficiary or beneficiaries must use the 10-year rule and a remainder beneficiary that is not a designated beneficiary will use the rules for non-designated beneficiaries.

(3) If the current see-through trust regulations are not changed, the current strategies for naming remainder beneficiaries of an accumulation trust will remain, e.g., use the siblings of the eligible designated beneficiary or nieces and nephews if there are no siblings, who will receive the retirement benefits outright at the death of the eligible designated beneficiary, so that the life expectancy of the eldest among all of those beneficiaries will be used to determine the applicable distribution period.

iv) Steve Trytten has an excellent idea for a fix to all of this. He suggests that the statute should add a provision that would state more or less as follows: "If a trust has an eligible designated beneficiary as its sole current beneficiary, the trust is considered an eligible designated beneficiary." Steve suggests additional provisions tailored to each type of eligible designated beneficiary so that the remainder beneficiary must use the 10-year rule, except, for a surviving spouse, or maybe a minor child of the account owner. Similarly, if the eligible designated beneficiary was no longer the sole beneficiary of a trust, then the 10-year rule would apply.

E. **The Account Owner's Minor Children under SECURE.** As noted earlier, the proposed law treats the minor children of the account owner differently than the other eligible designated beneficiaries. The planning may be a bit more flexible and less one-size fits all.

i) It may be appropriate to consider the use of a conduit trust for a minor child. The required minimum distributions will be small and the trustee can easily find a use for these required minimum distributions.

(1) The trustee should also be given powers to make additional distributions to or for the child's benefit. It may be preferable to use an independent trustee who can have broad discretionary powers to make distributions to or for the child.

(2) The broad discretionary power will allow the trustee to balance the needs of the beneficiary, who may be college bound and can continue the stretch until age 26 or may graduate after four years and start to work, when the 10-year rule will apply. In that way the trustee can balance the beneficiary's needs with the tax rates that will apply to the child or his or her surviving parent. Again, it will depend if Treasury adopts the defined benefit plan definition of a minor child for defined contribution plans if SECURE passes.

(3) The current version of the Kiddie Tax uses the trusts and estate rate schedule. IRC 1(j)(4). However, if the repeal of the current Kiddie Tax stays in the bill, a conduit trust may be more attractive with SECURE so that the child may be taxed at the parent's tax rates.

ii) An accumulation trust with broad discretionary powers in the trustee to withdraw from the inherited IRA and make distributions to the beneficiary may also be appropriate.

(1) If the child's parent is in the top tax bracket, it may make sense to accumulate the required minimum distributions within the trust to allow the inherited IRA (or other retirement account) to accumulate within the IRA for as long as the trustee may use the life expectancy method and the 10-year rule following the child reaching the age of majority. Of course, this assumes the repeal of the current version of the Kiddie Tax.

(2) If the current Kiddie Tax is not repealed, then an accumulation trust with broad discretionary powers may be a wash, depending on whether the trust has other assets in it that will make it subject to income tax and, possibly, the net investment income tax at the top trust tax bracket.

(3) Even if the current Kiddie Tax is not repealed, it is scheduled to sunset after 2025 so it may be worth "waiting out" the sunset and taking only required minimum distributions, if possible. Similarly, accumulating during the 10-year period may be a good strategy if it looks like tax rates will drop. Flexibility in drafting will be important. Elections will have consequences.

(4) If an inherited Roth IRA is payable to the child's trust, required minimum distributions will still be required. However, once the child ages out because he or she has reached the age of majority and is no longer in school, or reaches age 26, the 10-year rule will apply. When the 10-year rule applies, the trustee can stop withdrawing from the Roth IRA until the tenth year when the inherited IRA must be liquidated.

F. **Planning Ideas in Light of SECURE**

i) Roth IRA conversions and Roth accounts within qualified plans will likely become much more popular. The conversions will occur:

(1) In years when the account owner has lower income than usual and can afford a large conversion;

(2) Some NOLs or other non-recurring deductions that can offset the conversion; or

(3) More likely, on a systematic basis each year using either a stated sum or an amount that will keep the account owner in the same tax bracket.

Under the current brackets, the brackets increases can be substantial, e.g. 8-10%, or fairly insubstantial, e.g. 2-3%.

ii) Life insurance will become more popular among those who no longer feel the need for life insurance with a high estate tax exemption.

(1) Second-to-die policies will become good income replacements for those account owners who have smaller estates but will need to provide a cash infusion when the retirement benefits are no longer available as planned for their children.

(2) For those approaching or in retirement now, SECURE will hit their families particularly hard. They may no longer be insurable for a reasonable cost.

iii) A Net-Income-Makeup Charitable Remainder Unitrust may become a popular vehicle to mimic the stretch IRA for those with charitable intent.

(1) Per an analysis by Christopher Hoyt, the income beneficiary must be at least 27 years old for the NIMCRUT to work because of the need for the charity to receive at least 10% of the remainder.

(2) The NIMCRUT is not taxed when the retirement benefits are paid to the NIMCRUT.

(3) The beneficiary will be taxed at ordinary rates on the distributions from the NIMCRUT to the extent they represent income from the retirement account under the four-tier ordering rules for characterizing trust income in IRC 664(b)(1).

(4) The NIMCRUT is drafted to allow the trustee to pay the beneficiary the actual trust income in a year when it is less than the fixed income percentage stated in the trust. The shortfall is “made-up” in future years.

(5) The NIMCRUT has great possibilities but is certainly not as flexible as a trust that gives the trustee the power to make payments based on the current needs of the trust beneficiary.

iv) For some clients a NIMCRUT for a traditional IRA coupled with a substantial Roth IRA payable to an accumulation trust for the beneficiary may give the trustee enough income for the beneficiary’s needs. Indeed, for wealthier clients, the Roth IRA may be a very good combination with a NIMCRUT if the traditional IRA is paid to the NIMCRUT and starts income immediately and the Roth IRA is payable to the accumulation trust but allowed to accumulate within the inherited Roth IRA until the end of the tenth year.

v) Name both adult children and grandchildren as beneficiaries of the retirement accounts to share the tax pain and benefit from their ancestors’ generosity.

vi) For account owner who have substantial benefits, make charities the beneficiaries of the retirement accounts and make annual qualified charitable distributions that are tax-free instead of required minimum distributions once the account owner has attained age 70½. The law for the age to make qualified charitable distributions probably will not change from age 70½ even after the required beginning date changes to age 72.

III. Current Trust Rules[1]. The requirements for a trust to be a see-through trust, i.e., a trust that meets all of the requirements under Treas Reg 1.401(a)(9)-4, A-5, so that the trust beneficiaries are treated as the designated beneficiaries of the retirement account, look straightforward. The basic concept is the "see-through trust." The subsets of the see-through trust are accumulation trusts and conduit trusts.

A. A "see-through trust" must meet the following requirements:

i) The trust must be a valid trust under state law or would be but for the fact that there is no corpus.

ii) The trust must be irrevocable, or will, by its terms, become irrevocable on the death of the employee. See Treas Reg 1.401(a)(9)-5, A-7(c)(3), Ex 1-2.

(1) This includes testamentary trusts.

(2) The revocable trust does not have to state that the trust will become irrevocable as long as it will become irrevocable under state law.

(3) Beware of joint trusts that do not become irrevocable on the death of the first spouse, although recent rulings, especially in community property states where joint trusts are common, allow flexibility when the surviving spouse is the trustee and the marital trust (or the entire trust) is revocable because it grants the spouse a full right of withdrawal. Furthermore, a disclaimer into a joint trust that is not irrevocable will also fail as a see-through trust.

iii) The trust must have beneficiaries who are identifiable from the trust instrument within the meaning of Treas Reg 1.401(a)(9)-4, A-1. This is the hardest rule to meet.

iv) The trustee must provide the documentation described in Treas Reg 1.401(a)(9)-4, A-6, to the plan administrator. In general, the documentation must be provided to the plan administrator, IRA sponsor, or 403(b) sponsor, by October 31 of the year after the year of the account owner's death.

(1) The documentation is either the trust and any amendments or a list of all trust beneficiaries and their entitlements under trust, including remainder and contingent beneficiaries.

(2) Documentation may be required by the account owner's required beginning date if the account owner has named a trust where the spouse is the sole beneficiary and the spouse is more than 10 years younger than the account owner.

[1] Materials in this section of the outline were taken from a previous outline limited to inherited IRAs.

B. **Determining Identifiable Beneficiaries – Current Rule. The short definition of "identifiable" is that all trust beneficiaries that may receive a portion of the IRA, no matter how small, must be individuals.** The purpose of the September 30 deadline is to allow the trustee to pay creditors, charitable beneficiaries and older beneficiaries, even using IRA funds, so that as of the September 30 deadline the only beneficiaries remaining in the trust who have any right to a portion of the IRA are individuals. Disclaimer are also used to "change" the beneficiaries if completed within nine months of the account owner's death. Aside from the regulations, most of the law interpreting the "identifiable beneficiary" rule is made through private letter rulings.

C. **Analyzing a Trust – Current Rule**. In most instances, it is necessary to look at all possible beneficiaries at the September 30 deadline to determine whether the trust beneficiaries are identifiable and are individuals. All beneficiaries are considered or "counted" as beneficiaries from the grantor's date of death (ignoring beneficiaries whose interests are eliminated by the September 30 deadline) until an individual beneficiary or individual beneficiaries are identified who both: (i) are living at the death of the account owner; and (ii) take the retirement benefits outright from the trust. For this purpose, "outright" does not include a distribution of the retirement accounts when the beneficiary attains a certain stated age, for example. It means identifying a beneficiary or beneficiaries whose interest in the retirement account is immediately distributed to the beneficiary without any limitations as soon as the beneficiary's interest in the trust has ripened. In other words:

i) The beneficiary (individual or entity) is entitled to a portion of the IRA before the trust terminates as a current lifetime beneficiary or a remainder beneficiary;

ii) Once one or more trust beneficiaries are required to take the remaining IRA proceeds outright, all other subsequent beneficiaries, whether or not individuals, are not counted for purposes of determining whether all trust beneficiaries are identifiable.

iii) This analysis determines see-through status and the applicable distribution period based on the beneficiary with the shortest life expectancy.

D. **Contingent and Successor Beneficiaries – Current Rule.** Treas Reg 1.401(a)(9)-5, A-7(b) and (c)(1), discuss contingent and successor beneficiaries. Although not exclusive to trusts, this regulation is most problematic in the trust context, because most designations naming individuals give the primary beneficiary a complete right to withdraw the retirement account assets at any time, rendering the successor beneficiary's rights irrelevant.

i) Under Treas Reg 1.401(a)(9)-5, A-7(b), if a beneficiary has a contingent right, the remainder beneficiary will be counted in determining whether the account owner has a designated beneficiary, and which designated beneficiary has the shortest life expectancy (a "contingent beneficiary" under the regulations). In the language of the regulations, any 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" is considered a beneficiary of the trust. Treas Reg 1.401(a)(9)-5, A-7(c). This language in the regulations seems to indicate that almost any contingent beneficiary would have some contingent interest in the trust and would be counted.

ii) However, under Treas Reg 1.401(a)(9)-5, A-7(c)(1), if a person (i.e., a legal person whether or not an individual) could become the successor to the interest of a beneficiary only because of the prior beneficiary's death, that successor beneficiary will not be considered in determining whether there is a designated beneficiary, or which designated beneficiary has the shortest life expectancy. Indeed, to be a successor beneficiary, the *preceding* beneficiary's interest in the retirement account would have to:

(1) Be distributed outright to the beneficiary if he or she survives the account owner (or another prior beneficiary);

(2) Grant the beneficiary a complete right to withdraw the retirement account from the trust at any time (a lifetime general power of appointment), which may have to be exercised by the September 30 deadline; or

(3) Be a conduit trust, which requires the trustee to distribute to the beneficiary all withdrawals from the retirement account on receipt by the trustee.

E. **Accumulation Trusts and Conduit Trusts.** It is critical to understand the difference between an accumulation trust and a conduit trust. These terms are not defined in the Code or the regulations, but they have become terms of art in referring to the two types of trusts that are used when it is desirable to keep the IRA in trust for one or more beneficiaries, rather than having the trust distribute the IRA outright from the trust to the beneficiaries. The concept derives from Private Letter Ruling 200228025 (April 18, 2002), which was issued two days after the final regulations were issued.

i) **Accumulation Trust.** An "accumulation trust" is any trust that does not require the trustee to immediately distribute funds withdrawn from the IRA to the trust beneficiary or beneficiaries, whether the withdrawal is the required minimum distribution or a withdrawal for another purpose. **Examples of accumulation trusts** include trusts that:

(1) Give the trustee complete discretion to make distributions (or not).

(2) Pay trust income for life to the spouse, and require distributions of principal for support, maintenance, health and education, with the remainder outright to children in equal shares.

(a) This is the classic credit shelter trust. See Treas Reg 1.401(a)(9)-5, A-7(c)(3), Ex 1 and the private letter ruling cited above for examples of accumulation trusts.

(b) It can also be a QTIP marital trust, but it will not meet the requirements for a marital trust that is also the beneficiary of a retirement account. A QTIP trust that qualifies for the marital trust and has a retirement account payable to it must either distribute to the spouse at least annually, or give the spouse the continuing right to, the greater of: (A) all of the income in the IRA (or other retirement account) payable to the trust; or (B) the required minimum distribution.

(3) May or must pay trust income to the child and allows for lifetime distributions of principal using an ascertainable standard or trustee discretion and then pays one-third of trust principal to the beneficiary at age 25, one-half at 30, and the balance at age 35.

ii) **Conduit Trust.** A "conduit trust" is any trust that requires the trustee to immediately distribute funds withdrawn from the IRA to the individual trust beneficiary or beneficiaries whether the withdrawal is the required minimum distribution or a withdrawal for another purpose. See Treas Reg 1.401(a)(9)-5, A-7(c)(3), Ex 2 for the conduit trust example in the regulations.

(1) A conduit trust may be a separate trust for an IRA in the trust document, a stand-alone trust, or just provisions in a trust for an individual beneficiary that holds an IRA and other non-retirement assets. If the trust holds other assets, the conduit provisions apply only to the retirement accounts payable to the conduit trust. To meet the requirements for a conduit trust, the trust must:

(a) Distribute immediately any withdrawals from the IRA to or for the benefit of the beneficiary. (Note, not all attorneys are comfortable with payments "for the benefit of" the beneficiary since they are not part of the examples in the regulations or the private letter ruling that established the conduit trust concept. However, paying "for the benefit of" is mentioned in the Code and in other parts of the regulations.)

(b) Have its own taxpayer ID number. It cannot be merely a separate share.

(c) Become effective at the death of the IRA owner because the conduit trust is:

1. The primary beneficiary of the IRA;
2. The contingent beneficiary of the IRA that becomes primary because the primary beneficiary has not survived the IRA owner; or
3. The beneficiary as a result of the disclaimer by the original primary beneficiary of the IRA or interest in the trust to which the IRA is payable.

(2) A conduit trust automatically meets the see-through trust test, assuming the trustee sends the trust and any amendments to the IRA sponsor by the October 31 deadline.

F. **Comparison of Accumulation Trusts and Conduit Trusts.** There are two differences between accumulation trusts and conduit trusts.

i) For an **accumulation trust**, the life expectancy of each beneficiary that is still a trust beneficiary at the September 30 deadline (including a trust beneficiary who has died between the IRA owner's death and the September 30 deadline without having disclaimed his or her interest either before death or by his or her personal representative after death), must be considered part of the pool of potential beneficiaries until one or more beneficiaries can be identified that will take their shares of the IRA outright from the trust at the death of a prior beneficiary. **Examples**:

(1) Trust pays income for life to the spouse, and requires distributions of principal for support, maintenance, health and education, with the remainder outright to children in equal shares.

(a) Only the spouse and the children are counted in determining the life expectancy used for the applicable distribution period for required minimum distributions payable to the trust.

(b) This assumes the other requirements for a see-through trust are met.

(c) Any other beneficiaries are "mere successor beneficiaries."

(d) Absent a very young (second) spouse, the spouse's life expectancy will be used to determine the applicable distribution period.

(2) Trust pays income for life to the spouse, and requires distributions of principal for support, maintenance, health and education, with the remainder in trust for each child. The trustee can make discretionary distributions of income and principal to the child from the continuing trust. The trust will be terminated when the child attains age 30. If a child does not survive, his or her trust goes outright to his or her descendants, if there are no descendants, then to his or her siblings' trusts if under age 30, and if none of them survive, to the University of Michigan.

(a) If the children are all under age 30 and have no children at the death of the IRA owner, then the only beneficiary to take outright is the University of Michigan. The trust is not a see-through trust because the University of Michigan is not an individual. There is no designated beneficiary and the stretch is lost.

(b) If the children are all over age 30 at the death of the IRA owner, then they all take outright and the trust is a see-through trust. The spouse's life expectancy is used to determine the applicable distribution period.

(c) If the children are all under age 30 but have children at the death of the IRA owner, and the grandchildren will take outright, then the trust is a see-through trust but the spouse's life expectancy is still used to determine the applicable distribution period.

(3) If the original trust in (2) instead names individual beneficiaries rather than the University of Michigan to take outright if neither the spouse nor the IRA owner's children and descendants survive to the complete distribution of the trust, then the spouse, the spouse's children, and the individual beneficiaries named in the disaster distribution will all be "counted" as possible IRA beneficiaries and the oldest individual beneficiary's life expectancy will be used to determine the applicable distribution period for the required minimum distributions.

(4) If the trust is the same as the previous paragraph but the trust for the children has a general power of appointment to avoid the generation-skipping tax, the general power of appointment is treated as if there is no designated beneficiary for the trust and the trust fails as a see-through trust.

(i) The general power of appointment is not identifiable either because the beneficiary's estate or the beneficiary's creditors are beneficiaries or because the beneficiary can name anyone in the world or charities when exercising the power, including trusts that will not qualify as see-through trusts.

(ii) Likewise, some limited powers of appointment can also affect whether the trust qualifies as a see-through trust or what the applicable distribution period will be depending on the specific provisions of the limited power of appointment.

(iii) The trust beneficiary should consider disclaiming a power of appointment if it might cause a trust to fail the see-through trust rules.

ii) An **accumulation trust is best used** when the beneficiary needs protection from creditors, has substance abuse or gambling problems, is a spendthrift, is special needs, may need government benefits, is in a bad marriage, is in a high-risk profession, or for any other non-tax reason that requires a trustee to control distributions to the beneficiary. The Supreme Court ruled in *Clark v Rameker*, 573 US ___, 134 S Ct 2242 (2014) that an inherited IRA is not exempt from in bankruptcy, and therefore, an accumulation trust is safest for a trust beneficiary with creditor issues.

iii) A **conduit trust** that meets the other tests to qualify for see-through trust status has the following advantages:

(1) The life expectancy of the conduit trust beneficiary will be used to determine applicable distribution period for the required minimum distributions.

(2) The conduit trust can use the separate account rules. If an IRA is divided among several beneficiaries, including other trusts, *in the beneficiary designation*, the other beneficiaries' life expectancies will not be used to determine the applicable distribution period for the conduit trust's required minimum distributions.

(3) However, if the conduit trust has multiple beneficiaries, i.e., it is a sprinkle or pot trust, then the life expectancy of the oldest conduit trust beneficiary must be used to determine the applicable distribution period for the conduit trust required minimum distributions.

(4) The remainder beneficiaries of a conduit trust are irrelevant. If the conduit trust beneficiary lives to his or her full life expectancy, then the entire IRA will be distributed to the conduit trust beneficiary from the trust. This means the remainder beneficiaries can even be:

(a) Older than the conduit trust beneficiary;

(b) Charities; and

(c) Determined by a general or limited power of appointment.

(5) Even though the beneficiary will receive all of the IRA proceeds withdrawn from the IRA; perhaps indirectly by using the proceeds to pay the beneficiary's expenses; a conduit trust is useful to allow for professional administration of the trust, including investment management, and to allow the IRA to stay in a spendthrift trust until the trustee withdraws the required minimum distributions or other amounts.

(6) The trustee can also use the IRA proceeds to pay trustee fees. These are fees for the ongoing administration of the trust and not the administration of the trust after the IRA owner's death. They benefit the beneficiary.

iv) A conduit trust is best used for young children who will have very small required minimum distributions and beneficiaries who do not have special needs or other issues who can benefit from the asset protection of the spendthrift trust and will have the tax advantage of all withdrawals from the IRA being taxed at the beneficiary's individual tax rate instead of trust tax rates.

v) In general, under current rules, the trustee should never withdraw funds from an inherited IRA, except for required minimum distributions, unless the funds being withdrawn will be used immediately for the beneficiary, so the tax deferral within the inherited IRA can continue for as long as allowed under the regulations.

Questions? Contact me:

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