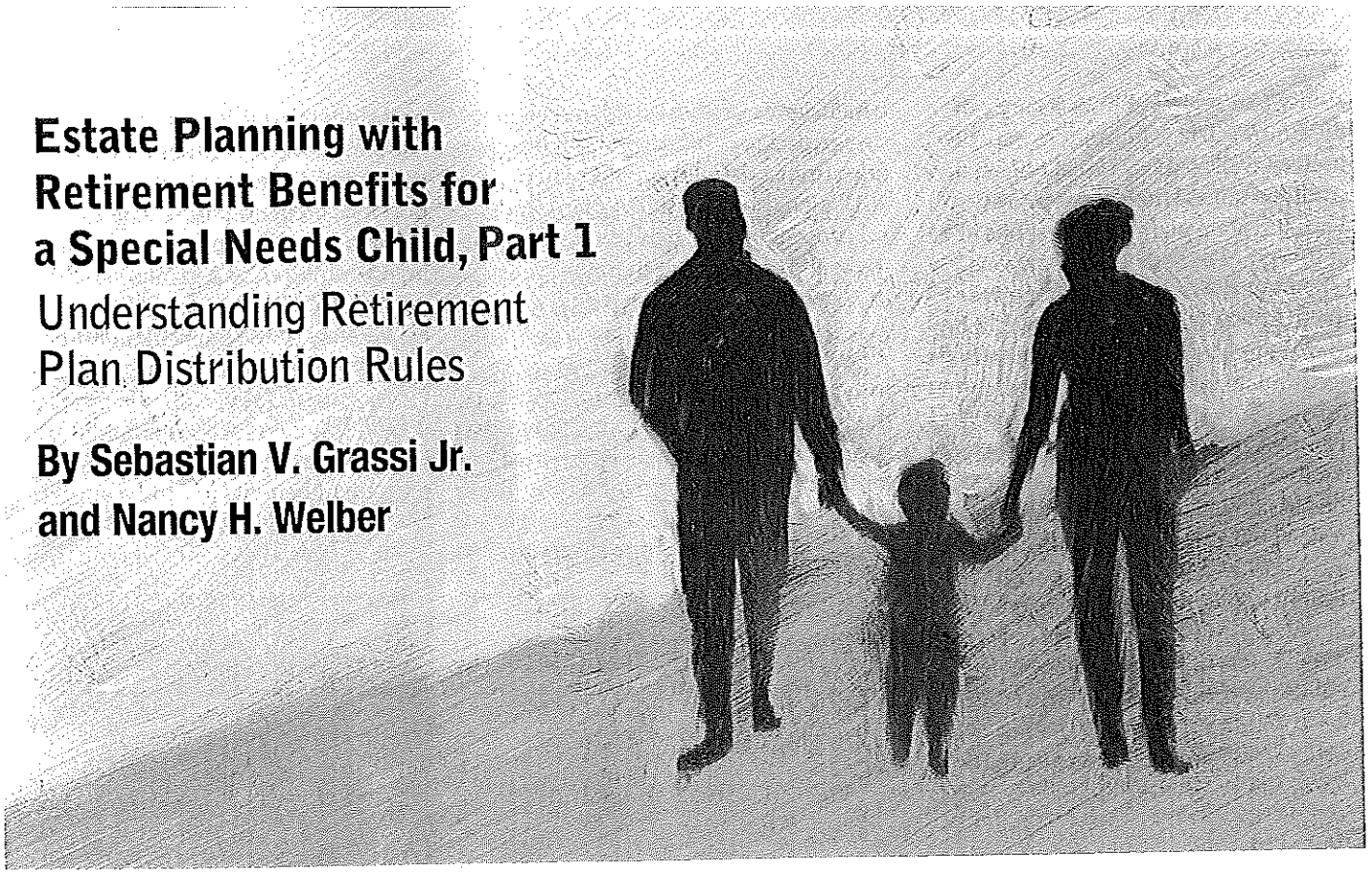
Estate Planning with Retirement Benefits for a Special Needs Child, Part 1

Understanding Retirement Plan Distribution Rules

By Sebastian V. Grassi Jr. and Nancy H. Welber



This article, which is divided into two parts, focuses on estate planning with defined contribution plans, which include profit-sharing plans (such as 401(k) plans), 403(b) tax-sheltered annuities, 457 plans, and IRAs in which, after the death of an account owner (and his or her spouse, who for purposes of this article is deemed to have predeceased the account owner), the beneficiary of the plan is the account owner's special needs child who is receiving (or otherwise eligible to receive) means-tested government benefits such as Supplemental Security Income (SSI) and Medicaid. See pages 14-21 of this issue. The article does not address defined benefit plans or other payouts from a retirement account in the form of an annuity, nor does it discuss nonqualified deferred compensation plans.

Practice Point: Many of the concepts discussed in this article are also applicable when the beneficiary-child is not a special needs child.

Part 1 of the article discusses retirement plan distribution rules and is relevant to all advisors who assist account owners or beneficiaries in retirement benefit plan distributions, especially when a trust is the beneficiary of the retirement account. Part 2 of the article, which will appear in the September/October issue, will discuss the types of trusts that can hold retirement benefits without jeopardizing a special needs child's receipt of means-tested government benefits.

Note: In 2009, the Worker, Retiree and Employer Recovery Act, H.R. 7327, Pub. L. No. 110-458, added Code § 401(a)(9)(H), which placed a moratorium on certain required minimum distributions from qualified retirement plans, Code § 403(b) and Code § 457 plans, and IRAs during 2009. Because the moratorium applies only to 2009, its effects are not discussed in this article, except with reference to Roth IRA conversions.

Key Dates for Retirement Account Distributions After the Account Owner's Death

To understand how to use retirement account benefits to fund a trust for the benefit of a special needs child, it is imperative that the advisor first understand the dates affecting payments to the deceased account owner's beneficiaries.

Year X1: Undistributed balance of deceased account owner's RMD due by 12/31/X1
Year X2: Shakeout period ends (beneficiary determination date) on 9/30/X2
Year X2: Trust documentation date due by 10/31/X2
Year X2: Beneficiary RBD and RMD due by 12/31/X2
Year X2: Separate account date due by 12/31/X2
Year X5: Five-year rule ends on 12/31/X5

Note: Year X1 = Year of the account owner's death. Year X2 = First calendar year after the calendar year of the account owner's death. Year X5 = Fifth calendar year after the calendar year of the account owner's death.

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Andrew O. Alcala

December 31 of the Year of Death (12/31/X1)

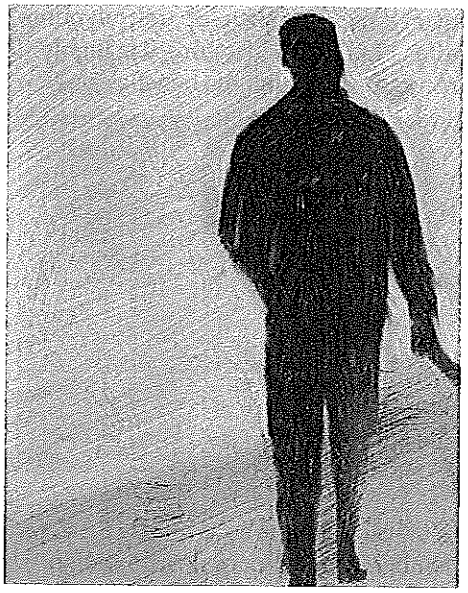
If the account owner dies after the required beginning date (RBD) for the retirement account in question and has not taken the full required minimum distribution (RMD) in the year of death, then the beneficiary of the retirement account must receive the undistributed balance of the (deceased) account owner's RMD by December 31 of the account owner's year of death (12/31/X1). Treas. Reg. § 1.401(a)(9)-5, A-4(a). If there is more than one beneficiary, the safest way to allocate the RMD is pro rata among the beneficiaries. Generally, the account owner will reach his or her RBD on April 1 of the year following the year the account owner attains age 70½, although there are exceptions. Note that the account owner of a Roth IRA is not required to take any RMDs during his or her lifetime and is always deemed to die before his or her RBD. When the account owner dies, however, the beneficiary of the Roth IRA (unless the beneficiary is the account owner's spouse who rolls over the Roth IRA into the spouse's own Roth IRA or treats the account as his or her own) must begin taking RMDs.

For an account owner who dies in 2010, the balance of the (deceased) account owner's RMD must be taken by 12/31/2010.

Practice Point: For account owners who die close to the end of the year, determining whether the deceased account owner took the RMD for the year of death is one of the first postmortem issues that should be examined if the account owner was over age 70½.

The "Shakeout Period" and the Beneficiary Determination Date (9/30/X2)

To calculate the minimum distribution for each year after the account owner's death, it is necessary to determine whether there is an *individual* (that is, a human being—a natural person) who is a designated beneficiary (DB) and, if multiple individuals or multiple *persons* (that is, individuals and non-individuals (such as an entity)) are beneficiaries, which beneficiary has the shortest life expectancy—because the beneficiary with the shortest life expectancy (such as an entity, which has a life expectancy of zero) will be used as the denominator in the minimum distribution equation. The determination of the identity of the DB or the beneficiary with the shortest life expectancy must occur by September 30 of the first calendar year after the calendar year of the account owner's death (9/30/X2). This date is sometimes referred to in this article as the "beneficiary determination date" (BDD). The period of time between the account owner's date of death and the beneficiary determination date is referred to as the "shakeout period."



For an account owner who dies in 2010, the BDD is 9/30/2011.

Practice Point: Not all beneficiaries are DBs. Certain trusts that meet the look-through trust rules (discussed below) may have individual beneficiaries who are DBs. Also, the lack of a DB does not necessarily preclude some form of stretch payout of the retirement benefits if the account owner dies after the RBD.

Trust Documentation Date (10/31/X2)

If a trust is named as a beneficiary of a retirement account, the following documentation must be provided to the plan administrator, including an IRA custodian, by no later than October 31 of the first calendar year after the calendar year of the account owner's death (10/31/X2): (1) a copy of the trust (and any amendments) or (2) the alternative certification of the trust beneficiaries as of the beneficiary determination date (9/30/X2). Treas. Reg. § 1.401(a)(9)-4, A-6(b).

TO UNDERSTAND HOW TO USE RETIREMENT ACCOUNT BENEFITS TO FUND A TRUST FOR THE BENEFIT OF A SPECIAL NEEDS CHILD, IT IS IMPERATIVE THAT THE ADVISOR FIRST UNDERSTAND THE DATES AFFECTING PAYMENTS TO THE DECEASED ACCOUNT OWNER'S BENEFICIARIES.

The alternative certification must include a final list of all beneficiaries of the trust (including contingent and remainder beneficiaries with a description of the conditions of their entitlement) as of the beneficiary determination date (9/30/X2), and the trustee must certify that, to the best of the trustee's knowledge, the list is correct and complete and that the other requirements are satisfied so that the trust beneficiaries will be deemed to be DBs. The trustee also must agree to provide a copy of the trust instrument (and any amendments) to the plan administrator on request.

As a practical matter, unless a plan administrator or IRA custodian insists on the alternative certification, it is easier to provide a copy of the trust, because providing a copy of the trust avoids concerns that omissions or other mistakes could occur in preparing the list of beneficiaries.

For an account owner who dies in 2010, the trust documentation date is no later than 10/31/2011.

Beneficiary RBD and RMD (12/31/X2)

The beneficiary's first RMD must be distributed by December 31 of the first calendar year after the calendar year of the account owner's death (12/31/X2), if the account owner dies (1) after the RBD or (2) before the RBD and (a) the five-year rule does not apply or (b) the five-year rule is not elected.

A nonspouse beneficiary has only until December 31 of the first calendar year after the calendar year of the account owner's death (12/31/X2) to effectuate a nonspouse beneficiary direct rollover from a qualified plan to an IRA and take the first RMD, if the qualified plan permits such a rollover. All qualified plans will be required to allow for a nonspouse beneficiary rollover for plan years beginning after December 31, 2009. Code § 402(c)(11), as amended by the Worker, Retiree and Employer Recovery Act, H.R. 7327, Pub. L. No. 110-458.

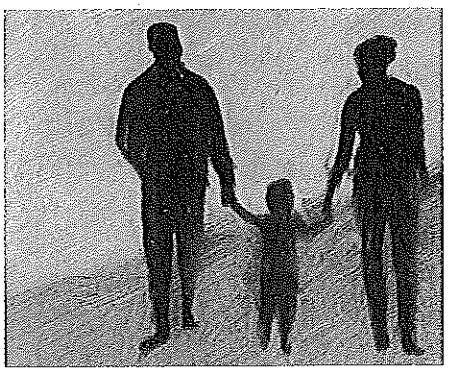
For an account owner who dies in 2010, the beneficiary RBD is 12/31/2011.

The Separate Account Date (12/31/X2)

The separate account date is also December 31 of the first calendar year after the calendar year of the account owner's death (12/31/X2). This is the date by which separate accounts have to be "established" to ignore the life expectancies of the other beneficiaries in determining the applicable distribution period, or the period over which the RMDs must be distributed for a particular beneficiary or beneficiaries. Treas. Reg. § 1.401(a)(9)-8, A-2(a)(2).

For example, an account owner names her three children as the beneficiaries of her IRA. If the children establish separate accounts by 12/31/X2, each child will be allowed to take the RMDs for that year and each succeeding year using the child's own life expectancy. In contrast, if the children fail to establish separate accounts by 12/31/X2, then the children will all have to take RMDs using the oldest child's life expectancy, even if they establish separate accounts after 12/31/X2. Therefore, it is highly recommended that the beneficiaries establish separate accounts by the September 30 beneficiary determination date (9/30/X2), especially (1) if a charity is named as a beneficiary of the retirement account (which, as discussed below, has a life expectancy of zero), (2) a trust is named as a beneficiary of the retirement account and the trust is not a look-through trust, or (3) if a beneficiary has been given a pecuniary interest in the retirement account (for example, $10,000 to my niece, Jessica Doe).

THERE ARE FOUR REQUIREMENTS FOR A TRUST TO BE A "LOOK-THROUGH TRUST."



For an account owner who dies in 2010, the separate account date is 12/31/2011.

Practice Point: Because a DB is determined by September 30 of the first calendar year following the calendar year of the account owner's death (9/30/X2), prudence suggests that separate accounts for each individual DB should be established no later than the beneficiary determination date (9/30/X2) for each individual DB to be considered the sole DB of their separate account.

Caution: The separate account rule is not available to a trust when the retirement account is payable to a master trust as the named beneficiary in the retirement account beneficiary designation form (such as the account owner's revocable living trust) and the master trust then states how the retirement account is to be divided and distributed among sub-trusts (or distributed outright and free of trust to the trust beneficiaries). See Treas. Reg. § 1.401(a)(9)-4, Q&A 5(c) ("the separate account rules under A-2 of § 1.401(a)(9)-8 are not available to beneficiaries of a trust with respect to the trust's interest in the employee's benefit"); however, naming sub-trusts directly in the beneficiary designation might allow for separate account treatment. PLR 200537044.

The Five-Year Rule (12/31/X5)

If the account owner dies before the RBD and there is no DB, then the retirement account must be paid out by the end of the fifth calendar year after the calendar year of the account owner's death (12/31/X5). This is known as the "five-year rule." During the period between the account owner's date of death and 12/31/X5, the retirement account can continue to accumulate income-tax free, and no minimum distributions are required to be made to the beneficiary. At the end of the five-year rule period (12/31/X5), however, the entire retirement account must be distributed to the beneficiary and will be subject to income taxes (less basis, if any).

For an account owner who dies in 2010, the last day for the retirement account to be paid out under the five-year rule is December 31, 2015, if there is no DB. Treas. Reg. § 1.401(a)(9)-3, A-2.

Trust Must Be a "Look-Through Trust" for Trust Beneficiaries to Be Considered as Designated Beneficiaries

Although, technically, a trust cannot be a DB because it is an entity with a life expectancy of zero, it is possible for a trust to have beneficiaries who are DBs. For a trust to have beneficiaries that are DBs, the trust must first be a "look-through trust" and meet all the requirements of Treas. Reg. § 1.401(a)

(9)-4, A-5(b). A "look-through trust" is often called a "see-through trust."

There are four requirements for a trust to be a "look-through trust."

1. The trust is a valid trust under state law, or would be but for the fact that there is no corpus.
2. The trust is irrevocable or, by its terms, will become irrevocable on the death of the account owner. This includes testamentary trusts. See Treas. Reg. § 1.401(a)(9)-5, A-7(c)(3), exs. 1 and 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.

   Caution: Beware of joint trusts that do not become irrevocable on the death of the first spouse account owner. These may not qualify as look-through trusts, unless the portion of the trust to which retirement benefits will be paid becomes irrevocable at the death of the first spouse account owner.
3. The beneficiaries of the trust who are the beneficiaries of the trust's interest in the account owner's retirement plan benefit are identifiable from the trust instrument within the meaning of Treas. Reg. § 1.401(a)(9)-4, A-1.

   Practice Point: This is the hardest rule to meet, because only beneficiaries who are individuals that are living at the death of the account owner and are still beneficiaries at the BDD (9/30/X2) can be DBs. But if no individual beneficiary who is living on the account owner's date of death can be identified by the BDD (9/30/X2), and who will be the last possible individual to take the retirement benefits outright, then there are no identifiable beneficiaries and the trust will not be a look-through trust. The determination of the applicable distribution period is then based on whether the trust is a look-through trust, that is, whether there is a DB and the other three rules for treating a trust as a look-through trust have been satisfied. It is only when there is a DB that the oldest individual's life expectancy is then used to determine the applicable distribution period (or whether the account owner's life expectancy would be used if the account owner dies after the RBD and the account owner was younger than the DB).
4. The documentation described in Treas. Reg. § 1.401(a)(9)-4, A-6 has been provided to the plan administrator. In general, the documentation must be provided to the plan administrator, IRA custodian, or 403(b) provider by October 31 of the year after the year of the account owner's death (10/30/X2).

THE MOST DIFFICULT LOOK-THROUGH TRUST REQUIREMENT TO SATISFY IS THAT THE TRUST HAS "IDENTIFIABLE" BENEFICIARIES WHO ARE INDIVIDUALS.

Ramifications If the Trust Is Not a Look-Through Trust and the Account Owner Dies on or *After* the Required Beginning Date

What if the trust is not a look-through trust (and therefore the trust beneficiaries are not considered DBs)? If the account owner dies *on or after* the RBD, then the applicable distribution period will be the account owner's (theoretical) remaining life expectancy. Likewise, if the oldest beneficiary is the account owner's sibling (perhaps with special needs), the payout result will be similar if the account owner and his or her sibling were close in age, especially if the account owner is the younger sibling. But, with the requirement starting in 2010 that qualified plans must provide a nonspouse DB, including the trustee of a look-through trust, with the option to roll over qualified plan benefits to an IRA, it will become more important for a trust to be classified as a look-through trust if the trust is the beneficiary of qualified plan benefits (as opposed to the beneficiary of IRA benefits). Under current law, the DB of qualified plan benefits may be "stuck" with a short distribution period, such as a lump-sum distribution or a five-year term certain. Beginning in 2010, DBs, including look-through trusts, may be able to greatly improve the stretch-out

of the retirement benefits payable to the trust through a nonspouse designated beneficiary rollover to an IRA and then take distributions based on the life expectancy of the beneficiary, or if he or she was younger, the account owner's theoretical remaining life expectancy. Moreover, if the account owner dies before his or her RBD, and the trust is not a look-through trust, then the five-year rule will apply, which can mean the loss of a significant stretch-out for the trust beneficiaries, especially if the beneficiaries are young children or a special needs child.

The Hardest Look-Through Trust Rule to Meet—All Trust Beneficiaries Must Be Identifiable Individuals

The most difficult look-through trust requirement to satisfy is that the trust has "identifiable" beneficiaries who are individuals. On its face, the identifiable

beneficiary rule appears simple. The practitioner, however, must do a great deal of analysis to assure himself or herself that, in fact, all potential trust beneficiaries have been considered, that all are identifiable, and that all of these identifiable beneficiaries are individuals (because only individuals can be DBs). The trustee has until no later than the beneficiary determination date (9/30/X2) to eliminate any trust beneficiary who is not an individual (such as a charity) or who has a shorter life expectancy than the account owner's intended recipient of the retirement account proceeds.

THE ACCOUNT OWNER'S ESTATE IS ALWAYS AN UNDESIRABLE BENEFICIARY, BECAUSE THE ESTATE IS AN ENTITY AND HAS A LIFE EXPECTANCY OF ZERO.

Eliminating the Interests of Certain Trust Beneficiaries

The inquiry into whether all beneficiaries are "identifiable" starts by looking at the trust document and deciding whether there are beneficiaries (especially entities) whose interests can and should be eliminated by the beneficiary determination date (9/30/X2). Beneficiaries whose interests should be eliminated include charities that are to receive pecuniary gifts under the trust. Those interests should be cashed out by the September 30 deadline (9/30/X2). See PLR 200608032. Likewise, an older individual beneficiary whose life expectancy might have to be considered when determining the applicable distribution period also should be cashed out by the September 30 deadline (9/30/X2), if possible. An alternative to cashing out the older individual beneficiary is to have that older beneficiary execute a qualified disclaimer under Code § 2518 to eliminate his or her interest in the trust. For example, elderly Aunt Susie might be included as a default beneficiary under the trust document. Aunt Susie could disclaim her interest in the trust, or in the retirement benefits payable to the trust, as long as the disclaimer is a qualified disclaimer under Code § 2518. Although the trustee may have until September 30 of the year after the year of death to determine the beneficiaries (9/30/X2), a qualified disclaimer must be made by the *earlier* of (1) nine months following the account holder's date of death or (2) the September 30 beneficiary determination date (9/30/X2). The nine-month rule concerning a qualified disclaimer of retirement benefits applies even if the beneficiary is a minor; and in such instance, a guardian may have to be appointed who can execute the disclaimer on behalf of the minor beneficiary.

Practice Point: Note that only those beneficiaries of an account owner who dies on December 30 or December 31 would have until 9/30/X2 to execute and deliver a qualified disclaimer. In all other instances, the qualified disclaimer would have to be executed and delivered before 9/30/X2.

Trust's Payment of Administration Expenses and Death Taxes from Retirement Account Proceeds

The account owner's estate is always an undesirable beneficiary, because the estate is an entity and has a life expectancy of zero. The IRS takes the position that the power to use retirement benefits payable to the trust to pay estate taxes and expenses of administration inures to the benefit of the account owner's estate and therefore makes the estate a beneficiary of the trust. This concept would apply whether the payment from the trust is required or discretionary. A trust with the power to pay administrative expenses and death taxes from retirement accounts could cause the trust to fail to be classified as a look-through trust. The IRS, however, has acknowledged that if all payments of expenses and taxes from retirement benefits payable to the trust occur on or before the September 30 beneficiary determination date (9/30/X2), the estate will not be considered a beneficiary of the trust. See PLRs 200432027, 200432028, and 200432029.

Suggested Will and Trust Provisions

As a planning matter, the account owner's trust (and/or will) should include a provision that either prohibits the use of retirement benefits for the payment of death taxes and administrative expenses or limits their payment to the period ending before September 30 of the first calendar year after the calendar year of the account owner's death (9/30/X2). A practitioner, however, might find that an outright prohibition is not suitable for a trust whose largest and most liquid asset is the retirement account. Whether or not the account owner's trust includes such a provision, it is also good practice to obtain an affidavit from the trustee stating that retirement benefits were not used to pay taxes and administrative expenses, or if they were, that they were paid before the September 30 deadline (9/30/X2). A practitioner may also want to obtain a private letter ruling for absolute certainty on the issue.

Effect of a Trust's Code § 645 Election to Be Treated as an Estate

The election by the trustee under Code § 645 to treat the account owner's revocable living trust as an estate for income tax purposes will not cause the trust to be classified as an estate for minimum distribution purposes. Because the trust is still a valid trust under state law, the Code § 645 election is irrelevant for minimum distribution purposes and the look-through trust rules. See the Preamble to Treas. Reg. §§ 1.401(a)(9)-0 through 1.401(a)(9)-9 (the "Final Regulations").

General Principles for Determining Whether All Remaining Trust Beneficiaries Are Identifiable and Are Individuals

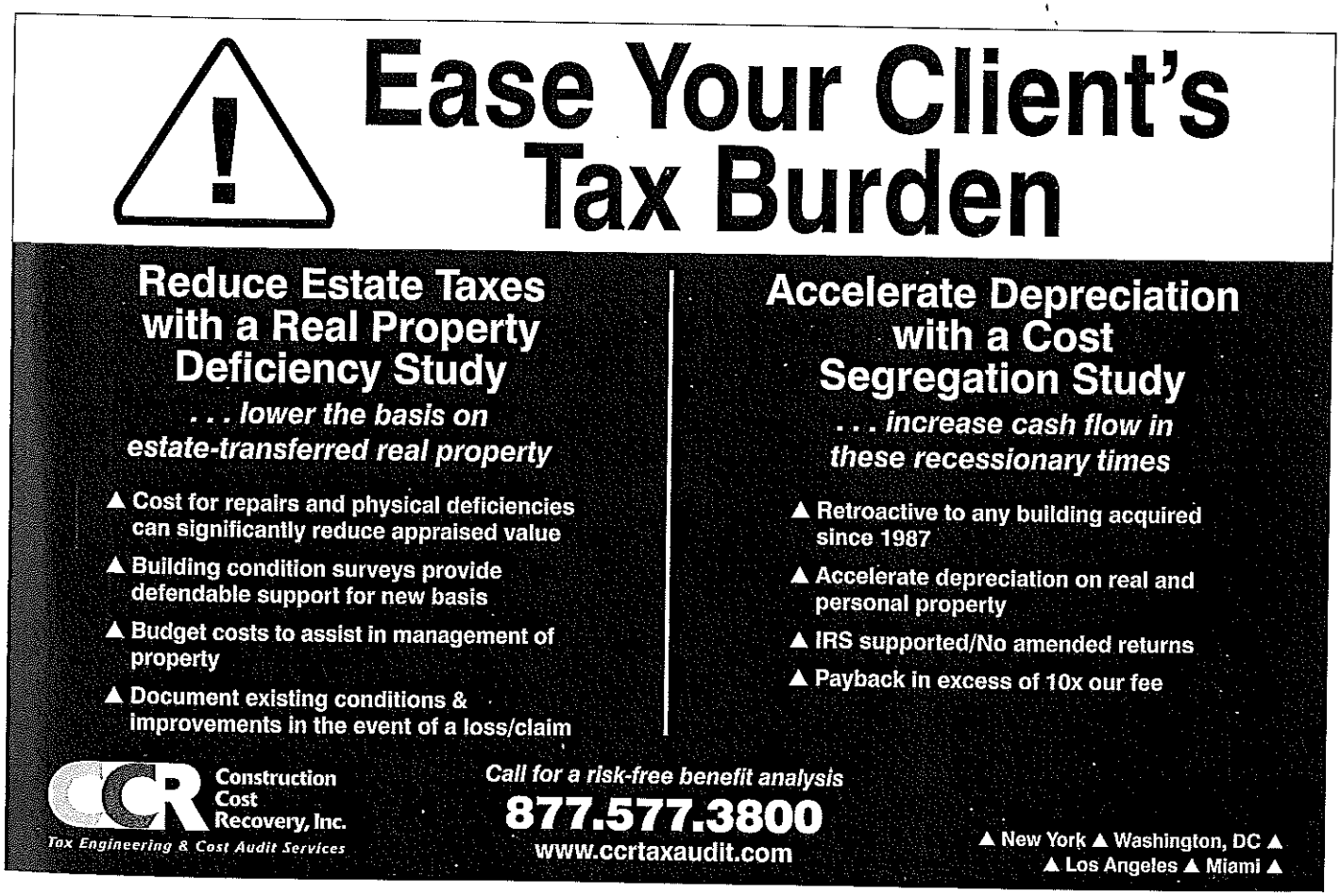
In most instances, it is necessary to look at all possible beneficiaries on the beneficiary determination date (9/30/X2) to determine whether the trust beneficiaries are identifiable and are individuals. (As previously mentioned, only individuals can be DBs.) In the minimum distribution context, the IRS does not view the beneficiary as the person who is entitled to income and principal at a given point in time. Rather, all trust beneficiaries are considered or "counted" as beneficiaries from the account owner's date of death (ignoring beneficiaries whose interests are eliminated by the beneficiary determination date (9/30/X2)) until a beneficiary or beneficiaries are found who are both

- living at the death of the account owner and
- entitled to take the retirement benefits outright from the trust either (1) at the death of the account owner or (2) at the death of another (prior) beneficiary who dies after the death of the account owner.

For this purpose, "outright" does not include a distribution of the retirement accounts when the individual beneficiary attains a certain stated age, such as age 30. It means identifying a beneficiary or beneficiaries whose interest in the retirement account is immediately distributed outright and free of trust (or the beneficiary is granted an unlimited power of withdrawal over the trust assets without any limitations) as soon as the individual beneficiary's interest in the trust has ripened without any (intervening) contingencies, such as having to attain a specified age before receiving all the retirement benefits outright and free of trust.

Mere Potential Successor Beneficiaries vs. Contingent Beneficiaries

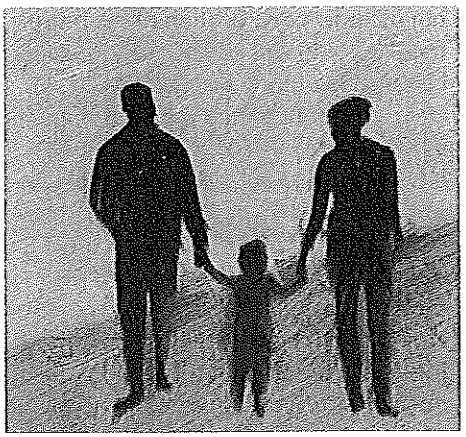
Under Treas. Reg. § 1.401(a)(9)-5, A-7(c)(1), if a person (that is, a legal person whether or not an individual) could become the successor to the interest of a beneficiary only because of the prior beneficiary's death, that potential "successor beneficiary" will not be considered (that is, the potential successor beneficiary will be ignored) in determining whether there is a DB or which DB has the shortest life expectancy. To be a potential "successor beneficiary" the *preceding* beneficiary's interest in the retirement account payable to the trust would have to be (1) distributed outright and free of trust to the preceding beneficiary if he or she survives the account owner (or



another prior beneficiary), (2) subject to a complete right to withdraw the retirement account from the trust at any time (a lifetime general power of appointment), or (3) held in a conduit trust, which requires the trustee to distribute to or for the benefit of the income beneficiary of the trust all withdrawals from the retirement account on the trustee's receipt of the withdrawals,

UNDERSTANDING THE REQUIRED DISTRIBUTION RULES IS ESSENTIAL FOR ESTATE PLANNING WITH RETIREMENT BENEFITS, PARTICULARLY IF A TRUST IS TO BE NAMED AS THE BENEFICIARY OF THE ACCOUNT OWNER'S RETIREMENT PLAN.

including any withdrawals in excess of the RMDs. If any of these three requirements are met, then all contingent remainder beneficiaries, including charities and those designated under a general power of appointment, are ignored for purposes of determining whether the beneficiaries are identifiable and whose life expectancy must be used to calculate the applicable distribution period. For example, if the trust states, "pay the retirement benefit outright and free of trust to my son, Joey, but if Joey does not survive me, then pay the retirement benefit to his issue outright and free of trust," and Joey survives the account owner, then Joey is the DB, and Joey's then living issue are mere potential "successor beneficiaries," whose life expectancies are not considered and the search for "identifiable" beneficiaries stops with



Joey. If, however, Joey does not survive the account owner, Joey's then-living issue who survive the account owner are the DBs, and the search for "identifiable" beneficiaries stops with Joey's then-living issue, and the practitioner does not have to consider any contingent beneficiaries such as those contained in a trust's "wipe out clause" (which typically includes the account owner's heirs-at-law and a potential charity as contingent beneficiaries of the trust). Thus, Joey's oldest living descendant's life expectancy would be used to determine the applicable distribution period.

Many practitioners limit after-adopted trust beneficiaries to those who are younger than the oldest beneficiary of the trust as of the account owner's date of death. This restriction eliminates the potential problem of adoption of older children and adults after the account owner's date of death and the beneficiary determination date (9/30/X2). The mere possibility that such adoptions could occur means that a trust's beneficiaries could never be identifiable and the trust would not qualify as a look-through trust, and therefore, there would be no DB.

Trust Reformations to Fix Problems Discovered After the Account Owner's Death

Until recently, the IRS has granted look-through trust status to trusts that could not easily eliminate their beneficiary problems using qualified disclaimers and cashouts by the beneficiary determination date (9/30/X2). The trustee would petition the local probate court and obtain a trust reformation by the beneficiary determination date (9/30/X2) and then seek a PLR on the status of the trust post-reformation. See, e.g., PLRs 200616039 and 200616040. At a May 2008 ALI-ABA CLE seminar on retirement benefits, however, an IRS representative stated that the IRS will probably no longer rule favorably in trust reformation requests unless (1) the trust document specifically authorizes the trustee to seek a reformation or amendment or (2) there is a legitimate case or bona fide controversy before the court that the IRS would otherwise honor in making a determination on the issues. Such enabling language is now advisable in all trusts that are named as beneficiaries of retirement accounts, even if the trust is a contingent beneficiary of the retirement account. Such language is especially important in a special needs trust situation in which a change in the rules concerning means-tested government benefits for a special needs child, or a change in family circumstances, may unexpectedly create a situation that even the most careful planner could not anticipate.

Conclusion

Understanding the required distribution rules is essential for estate planning with retirement benefits, particularly if a trust is to be named as the beneficiary of the account owner's retirement plan. Part 2 of this article, which will appear in the September/October issue, will focus on the type of trust to use when the account owner wants to leave retirement plan benefits to his or her special needs child in a manner that will not jeopardize the child's eligibility to receive means-tested government benefits. ■

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