

**STATE BAR OF CALIFORNIA
TAXATION SECTION
ESTATE AND GIFT TAX COMMITTEE¹**

**PROPOSAL TO CLARIFY TREASURY REGULATION
SECTION 1.401(a)(9)-5, A-7**

This proposal was principally prepared by John W. Prokey, Vice Chair of the Estate and Gift Tax Committee of the Taxation Section of the State Bar of California. The author wishes to thank Natalie B. Choate and Andrew M. Katzenstein for their valuable contributions to this paper.²

Contact Person:	John W. Prokey
	Fiore • Ramsbacher LLP
	125 S. Market Street, Suite 1150
	San Jose, California 95113
	Phone: (408) 293-3616
	Facsimile: (408) 293-0430

¹ The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the State Bar of California or the Los Angeles County Bar Association.

² Although the participants on the project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this subject.

EXECUTIVE SUMMARY

On April 16, 2002, the Treasury Department issued Treas. Reg. §§1.401(a)(9)-1 through 1.401(a)(9)-9 and 1.401(a)(9)-6T, the long-awaited final minimum distribution regulations (the “Final Regulations”) under Internal Revenue Code §401(a)(9). In most respects, the Final Regulations are a welcomed simplification over the 1987 and 2001 proposed regulations. However, naming trusts that may accumulate IRA distributions as IRA beneficiaries is now more confusing and perhaps a trap for the unwary.

The Final Regulations provide guidance on which trust beneficiaries must be taken into account when determining (i) whether an IRA has a “designated beneficiary”, and (ii) the identity of the oldest beneficiary for purposes of determining required minimum distributions. However, when applied to a trust that may accumulate IRA distributions, it is unclear in certain cases whether the IRA will be considered to have a designated beneficiary and the identity of the oldest trust beneficiary. Plan administrators, taxpayers and their advisors are left exposed to unexpected consequences. The safe harbor “conduit trust” does not adequately address taxpayers' desire to restrict beneficiary access to IRA distributions. Therefore, the Treasury should provide further guidance under Treas. Reg. §1.401(a)(9)-5, A-7 that provides plan administrators, taxpayers and their advisors with a bright-line test to easily determine the minimum distributions required from an IRA with a trust beneficiary. This paper suggests the types of guidance Treasury should provide to clarify these rules.

DISCUSSION

I. CURRENT LAW AND REASON FOR PROPOSED CHANGE

A. Applicability of the Final Regulations

The Final Regulations apply to a wide range of pension, profit sharing and individual retirement plans, thus this paper is generally applicable to all plans subject to Treas. Reg. §§1.401(a)(9)-1 through 1.401(a)(9)-9 and 1.401(a)(9)-6T, which of course, also includes IRAs pursuant to Treas. Reg. §1.408-8, A-1. For ease of reference, this paper uses the term “IRA” to refer to plans and retirement accounts subject to the Final Regulations. Further, as in the Final Regulations, the plan participant is referred to herein as the “employee”.

B. Required IRA Distributions After Employee’s Death

The time period over which a deceased employee’s IRA account must be distributed after his or her death depends largely on the identity of the IRA beneficiary. If benefits are left to a “designated beneficiary”, the applicable distribution period (“ADP”) is the life expectancy of that designated beneficiary. A “designated beneficiary” is defined as an individual, a group of individuals or a qualifying trust.³ Thus, an employee’s estate, a charity and a non-qualifying trust do not qualify as a designated beneficiary.⁴

If the benefits are left to a beneficiary who does not meet the definition of a designated beneficiary, the benefits must generally be distributed over a shorter time period: the benefits must be distributed within five years after the employee’s death (in the case of an employee who died before his or her required beginning date -- approximately age 70 ½), or over what would have been the remaining life expectancy of the employee (in the case of an employee who died after his or her required beginning date).⁵

³ Treas. Reg. §1.401(a)(9)-4, A-3 and A-5.

⁴ Id.

⁵ IRC §401(a)(9)(A)(ii) and IRC §401(a)(9)(B)(i)

C. Trusts Essential Part of Estate Planning

Employees commonly desire estate plans that leave their assets in trust for family members rather than outright. Typical situations in which an employee would choose to name a trust, rather than an individual, as a beneficiary of an IRA include:

- The employee wants to leave the IRA to a child, but the child is too young to handle money responsibly. Parents regularly delay the age of inheritance for their descendants to ages between 25 and 45.
- The employee wants to leave the IRA to the employee's surviving spouse for his or her lifetime, with the IRA ultimately passing to the employee's descendants after the surviving spouse's death. This structure is frequently used for estate tax reasons ("credit shelter" or "bypass trust"), or where the employee's spouse is not the parent of the employee's children.
- Other situations in which the employee has concerns that require protection of the assets in a trust (beneficiary who is a spendthrift, has substance abuse problems, is subject to lawsuits or is a special needs beneficiary).

Because the ADP that applies to a designated beneficiary is more favorable (longer) than the ADP applicable to other beneficiaries, employees leaving benefits to a trust for their family members will generally seek to have such a trust qualify for the longest possible ADP.

If it is not clear whether a trust qualifies as a designated beneficiary, employees are forced to choose between a rock and a hard place: either the employee leaves his or her benefits to a trust, thus using responsible estate planning but giving up the tax deferral rights available for designated beneficiaries; or the employee leaves his or her benefits outright to individuals, thus preserving for them the option of the desirable "life expectancy payout", but sacrificing other important estate planning objectives such as protecting minor beneficiaries.

The Treasury has attempted to define which trusts qualify as a designated beneficiary and which trust beneficiaries are counted for purposes of determining the ADP, but has failed to provide guidance that practitioners can understand or follow.

D. Trust as Designated Beneficiary

Generally, a trust cannot be a “designated beneficiary” because it is not an “individual” with a life expectancy.⁶ However, if a trust is named as a beneficiary and certain requirements specified in Treas. Reg. §1.401(a)(9)-4, A-5 are met, the beneficiaries of such trust, and not the trust itself, will be treated as the named beneficiaries of the employee’s IRA for purposes of determining the ADP under §401(a)(9). In other words, if a trust is named as the beneficiary of an IRA, and the trust meets the requirements of Treas. Reg. §1.401(a)(9)-4, A-5, the trust is “looked-through” and the trust beneficiaries are examined. A trust meeting the requirements of Treas. Reg. §1.401(a)(9)-4, A-5 is referred to herein as a “look-through trust”. The requirements of Treas. Reg. §1.401(a)(9)-4, A-4 are as follows:

- (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 will, by its terms, become irrevocable upon the death of the employee.
- (3) The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable within the meaning of A-1 of this section from the trust instrument.
- (4) The documentation described in Treas. Reg. §1.401(a)(9)-4, A-6 has been provided to the plan administrator.⁷

⁶ Treas. Reg. §1.401(a)(9)-4, A-3

⁷ Treas. Reg. §1.401(a)(9)-4, A-5

E. Determining Trust Beneficiaries

When a look-through trust is named as an IRA beneficiary, the identity of the trust beneficiaries determines who is the designated beneficiary. Generally speaking, if more than one individual is named as a beneficiary, the beneficiary with the shortest life expectancy will be the designated beneficiary for purposes of determining the ADP.⁸ If a charity or an estate is one of the trust beneficiaries, the trust does not qualify as a designated beneficiary.⁹

1. *Treas. Reg. §§1.401(a)(9)-5, A-7(b) and (c)*

Trusts are a means in which individuals can set aside funds to be held by a trustee for one or more individual beneficiaries (such as the employee's spouse or children) until the occurrence of an event (such as the spouse's death, or a child's attaining a certain age). When the event occurs, the trust typically terminates and the remaining trust assets pass outright to the same or another individual. For example, on the death of a spouse the trust assets pass to the children; or on a child's attaining a certain age, the assets are distributed outright to the child. Because of the uncertainty of life, the trust instrument must cover all eventualities, however unlikely to occur. Thus, a typical trust would provide for an "ultimate" or "wipe-out" beneficiary to take the trust assets if, for example, all of the employee's descendants predecease the spouse, or a child dies before reaching the age for scheduled distribution. These remote contingent beneficiaries could be the employee's estate, a charity, a beneficiary's estate, or more distant relatives or heirs of various ages.

Since the beneficiaries of a look-through trust determine whether the trust qualifies as a designated beneficiary and the identity of the individual beneficiary with the shortest life expectancy, it is imperative to understand which trust beneficiaries are "counted" when making this determination. The principal guidance for determining which contingent and successor beneficiaries of a look-through trust are counted is *Treas. Reg. §§1.401(a)(9)-5, A-7(b) and (c)*, which provide as follows:

⁸ *Treas. Reg. §1.401(a)(9)-5, A-7(a)(1)*.

⁹ *Treas. Reg. §1.401(a)(9)-5, A-7(a)(2)*, referring to *Treas. Reg. §1.401(a)(9)-4, A-3*.

“(b) *Contingent beneficiary*. Except as provided in paragraph (c)(1) of this A-7, if a beneficiary’s entitlement to an employee’s benefit after the employee’s death is a contingent right, such contingent beneficiary is nevertheless considered to be a beneficiary for purposes of determining whether a person other than an individual is designated as a beneficiary (resulting in the employee being treated as having no designated beneficiary under the rules of A-3 of §1.401(a)(9)-4) and which designated beneficiary has the shortest life expectancy under paragraph (a) of this A-7.

(c) *Successor beneficiary*--(1) A person will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy under paragraph (a) of this A-7, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the employee’s beneficiaries after that beneficiary’s death. However, the preceding sentence does not apply to a 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. Thus, for example, if the first beneficiary has a right to all income with respect to an employee’s individual account during that beneficiary’s life and a second beneficiary has a right to the principal but only after the death of the first income beneficiary (any portion of the principal distributed during the life of the first income beneficiary to be held in trust until that first beneficiary’s death), both beneficiaries must be taken into account in determining the beneficiary with the shortest life expectancy and whether only individuals are beneficiaries.”

Read literally, Treas. Reg. §§1.401(a)(9)-5, A-7(b) and (c) require *all* beneficiaries, except those who could merely become the successor to the interest of one of the employee’s beneficiaries after that beneficiary’s death, to be counted. There is no regard to actuarial life expectancies. Thus, even contingent beneficiaries with a less than 5% chance of receiving any trust benefits, based on actuarial life expectancies, must be considered. Further, if there is any possibility a charity or other non-individual is a contingent trust beneficiary, the employee will be treated as having no designated beneficiary, resulting in such employee’s beneficiary being denied use of an ADP based on the principal trust beneficiary’s lifetime.

2. *Treas. Reg. §1.401(a)(9)-5, A-7(c)(3), Example 1*

While *Treas. Reg. §§1.401(a)(9)-5, A-7(b) and (c)*, when read literally, require *all* beneficiaries be counted, Example 1 of *Treas. Reg. §1.401(a)(9)-5, A-7(c)(3)* indicates a different result. Example 1 provides as follows:

“(i) Employer M maintains a defined contribution plan, Plan X. Employee A, an employee of M, died in 2005 at the age of 55, survived by spouse, B, who was 50 years old. Prior to A’s death, M had established an account balance for A in Plan X. A’s account balance is invested only in productive assets. A named a testamentary trust (Trust P) established under A’s will as the beneficiary of all amounts payable from A’s account in Plan X after A’s death. A copy of the Trust P and a list of the trust beneficiaries were provided to the plan administrator of Plan X by October 31 of the calendar year following the calendar year of A’s death. As of the date of A’s death, the Trust P was irrevocable and was a valid trust under the laws of the state of A’s domicile. A’s account balance in Plan X was includible in A’s gross estate under §2039.

(ii) Under the terms of Trust P, all trust income is payable annually to B, and no one has the power to appoint Trust P principal to any person other than B. A’s children, who are all younger than B, are the sole remainder beneficiaries of the Trust P. No other person has a beneficial interest in Trust P. Under the terms of the Trust P, B has the power, exercisable annually, to compel the trustee to withdraw from A’s account balance in Plan X an amount equal to the income earned on the assets held in A’s account in Plan X during the calendar year and to distribute that amount through Trust P to B. Plan X contains no prohibition on withdrawal from A’s account of amounts in excess of the annual required minimum distributions under section 401(a)(9). In accordance with the terms of Plan X, the trustee of Trust P elects, in order to satisfy section 401(a)(9), to receive annual required minimum distributions using the life expectancy rule in section 401(a)(9)(B)(iii) for distributions over a distribution period equal to B’s life expectancy. If B exercises the withdrawal power, the trustee must withdraw from A’s account under Plan X the greater of the amount of income earned in the account during the calendar year or the required

minimum distribution. However, under the terms of Trust P, and applicable state law, only the portion of the Plan X distribution received by the trustee equal to the income earned by A's account in Plan X is required to be distributed to B (along with any other trust income.)

(iii) Because some amounts distributed from A's account in Plan X to Trust P may be accumulated in Trust P during B's lifetime for the benefit of A's children, as remaindermen beneficiaries of Trust P, even though access to those amounts are delayed until after B's death, A's children are beneficiaries of A's account in Plan X in addition to B and B is not the sole designated beneficiary of A's account. Thus the designated beneficiary used to determine the distribution period from A's account in Plan X is the beneficiary with the shortest life expectancy. B's life expectancy is the shortest of all the potential beneficiaries of the testamentary trust's interest in A's account in Plan X (including remainder beneficiaries). Thus, the distribution period for purposes of section 401(a)(9)(B)(iii) is B's life expectancy. Because B is not the sole designated beneficiary of the testamentary trust's interest in A's account in Plan X, the special rule in 401(a)(9)(B)(iv) is not available and the annual required minimum distributions from the account to Trust M must begin no later than the end of the calendar year immediately following the calendar year of A's death."

Example 1 states "A's children, who are all younger than B, are the sole remainder beneficiaries of the Trust P" and concludes that the person among A's children and B with the shortest life expectancy is the measuring life. What happens to the trust if A dies, followed by B and all A's children? The remaining trust assets would likely revert to A's estate, which is ignored in Example 1. An estate is not an individual as defined under Treas. Reg. §1.401(a)(9)-4, A-3, and thus Trust A would not have a designated beneficiary. A literal reading of Treas. Reg. §§1.401(a)(9)-5, A-7(b) and (c) appear to be inconsistent with the conclusion of Example 1.

3. Can §§1.401(a)(9)-5, A-7(b) and (c) and Example 1 be Reconciled?

There have been many attempts to reconcile Treas. Reg. §§1.401(a)(9)-5, A-7(b) and (c) and Example 1. Perhaps Example 1 intends

to suggest that if a beneficiary is not specifically named in a look-through trust, the beneficiary is ignored. This is unlikely, as such an interpretation would lead to abuses.

Perhaps Example 1 indicates that only B, the primary beneficiary, and A's children, the remainder beneficiaries, are counted for determining the designated beneficiary, suggesting contingent remainder beneficiaries are ignored. This is also unlikely because Example 1 states that Trust P's sole remainder beneficiaries are A's children. The fact is, taxpayers and their advisors have not been able to satisfactorily reconcile Treas. Reg. §§1.401(a)(9)-5, A-7(b) and (c) and Example 1.

An unnatural or unexpected order of death can leave no named beneficiary standing, and cause a reversion to the estate of the trust settlor or beneficiary. Thus, Trust P in Example 1 is a trust that cannot exist, as the trustor's estate would have likely been the contingent remainder beneficiary.

4. *Past Guidance from the Treasury Department*

The 1987 and 2001 Proposed Regulations contained a death contingency limiting counted trust beneficiaries. If a trust beneficiary's entitlement to an IRA is contingent on the death of a prior beneficiary, such contingent beneficiary is not counted for purposes of determining the identity of the beneficiary with the shortest life expectancy or whether a beneficiary who is not an individual is a beneficiary under the 1987 and 2001 Proposed Regulations.¹⁰ The death contingency was also supported in Private Letter Rulings prior to 2002.¹¹

5. *Does the Death Contingency Live on in §1.401(a)(9)-5, A-7(c)?*

The death contingency, at first glance, appears to be contained in the "successor beneficiary" description of Treas. Reg. §1.401(a)(9)-5, A-7(c). This section begins by stating "A person will not be

¹⁰ See Prop. Reg. §1.401(a)(9)-5, A-7(b), (e)(1) (2001) and Prop. Reg. §1.401(a)(9)-1, E-5(b), (e)(1) (1987).

¹¹ See PLR 9820021, PLR 199912041, PLR 9846034, PLR 9848032, PLR 9809059 and PLR 9739034.

considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy under paragraph (a) of this A-7, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death." The language suggests that a contingent remainder trust beneficiary is not counted because there is only a "mere possibility" he could become the successor in interest to the IRA. This is especially true if two sets of beneficiaries, the primary and remainder beneficiaries, must die before the contingent remainder trust beneficiary succeeds to any interest in the IRA. This interpretation is reasonable in light of past guidance from the Treasury Department.

Treas. Reg. §1.401(a)(9)-5, A-7(c)(1) goes on to say "However, the preceding sentence does not apply to a 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." The difficult part of this sentence is that there is no definition of what a right "beyond being a mere potential successor" would be. The next sentence of Treas. Reg. §1.401(a)(9)-5, A-7(c)(1) provides an example essentially identical to Example 1, and thus provides no further guidance.

Absent sufficient guidance in Treas. Reg. §1.401(a)(9)-5, A-7(c), one would think based on the 1987 and 2001 Proposed Regulations and private letter rulings interpreting such regulations, that the death contingency is still alive and well. One might also think that since a beneficiary must have a right "beyond being a mere potential successor" in order to be counted, those beneficiaries with a remote possibility of receiving any benefit from a trust would not be counted.

To illustrate the point, let's assume an individual, named Trustor has an IRA account. Trustor names Trust X as beneficiary of the IRA. Trust X provides that distributions to Trustor's two grandchildren are to be made in the discretion of the trustee for their support, health and maintenance until age 30, at which time, each grandchild can withdraw his entire share. If either grandchild dies before age 30, such grandchild's share is to be distributed to the other grandchild. Thus, each grandchild is the remainder beneficiary of the other's share. If both grandchildren die before age 30, the entire trust will be distributed to contingent remainder beneficiaries. The oldest contingent remainder beneficiary is 67.

Since each grandchild is the remainder beneficiary of the other's trust and both must die before a contingent beneficiary takes any portion of the IRA, it appears the contingent remainder beneficiaries would not be counted pursuant to the death contingency from the 1987 and 2001 proposed regulations. It also appears that there is only a "mere possibility" the contingent beneficiaries could become the successors in interest to the IRA. After all, both grandchildren would have to die before reaching age 30. Thus, one would assume that the oldest of the grandchildren would be the designated beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy.

6. *Guidance from Private Letter Ruling 200228025*

In Private Letter Ruling 200228025, on these facts, the Service reached a very different conclusion. The Service ruled that the required minimum distributions from the IRA must be based on the life expectancy of the oldest beneficiary, including contingent beneficiaries named in the trust. All contingent beneficiaries were included, thus the required minimum distributions were based on the 67 year old contingent beneficiary. PLR 200228025 appears to contradict prior private letter rulings that ignored beneficiaries with a remote possibility of taking an interest in the IRA.

III. SAFE HARBOR

Some argue that the issue is resolved with so-called "conduit trusts" created by Example 2 of Treas. Reg. §1.401(a)(9)-5, A-7(c)(3). A conduit trust is a trust that requires the trustee to pay all amounts distributed from an IRA directly to a specific beneficiary upon receipt by the trustee.¹² The trust beneficiary entitled to receive the IRA distributions for his or her lifetime is referred to herein as the "conduit beneficiary". The only beneficiary of a conduit trust counted for purposes of determining the identity of the beneficiary with the shortest life expectancy and whether a person who is not an individual is a beneficiary, is the conduit beneficiary.¹³ Thus, conduit trusts provide a safe harbor against the issues presented by near infinite contingent trust beneficiaries.

¹² Treas. Reg. §1.401(a)(9)-5, A-7(c)(3), Example 2.

¹³ Id.

The conduit trust appears to be an example of when a successor trust beneficiary merely “could become the successor to the interest” of the conduit beneficiary. The problem is that it is not clear whether this is the only type of trust that allows a trust beneficiary to not be counted. Most practitioners (and the Treasury as indicated by Example 1) believe that trusts can be drafted in such a way as to ignore contingent remainder beneficiaries without being conduit trusts. If not, millions of individuals will have to revise their estate plans at substantial cost because they and their advisors relied on the 1987 and 2001 Proposed Regulations.

A. Unavailable Safe Harbor

The real problem with conduit trusts is that they are not practical for most estate planning situations, and thus they are a safe harbor unavailable to many individuals. It is in the best interests of many beneficiaries (such as minor beneficiaries, spendthrifts and special needs beneficiaries) to accumulate required minimum distributions from an IRA within a trust. A trust which can accumulate IRA distributions is referred to herein as an “accumulation trust”.

The underlying purpose of most trusts is to prevent minor and irresponsible children from receiving assets outright. Accumulation trusts are therefore critical to many employees and the protection of their descendants. Conduit trusts are directly opposed to trust purposes and leave employee descendants financially exposed.

B. Income Tax – Accumulation and Conduit Trusts

Practically speaking, the only real difference between a conduit trust and an accumulation trust is the ability to accumulate IRA distributions within the trust. This has tremendous implications for estate planning and income tax deferral, yet it has minimal income tax implications for yearly required minimum IRA distributions and on the ultimate recipient of the IRA benefits. This is not to say there is little income tax difference between a 5 year required payout and a payout based on a 30 year life expectancy. It is to say there is little income tax difference between a beneficiary immediately receiving an IRA distribution and accumulating that IRA

distribution within a trust.¹⁴ The Final Regulations allow both conduit trusts and accumulation trusts to be looked through, thus it appears the Treasury Department is not concerned with the income tax treatment of yearly minimum IRA distributions.

C. Inconsistent Results

The Final Regulations allow for circumstances in which an IRA payable to a trust is guaranteed to pass to a non-individual beneficiary, while that non-individual beneficiary is not counted for purposes of determining who is the beneficiary with the shortest life expectancy and whether a person who is not an individual is a beneficiary. On the other hand, there are circumstances in which there is a less than 1% chance that any portion of the IRA will pass to a non-individual beneficiary, yet the trust would be denied use of the life expectancy payout method.

For example, assume A dies leaving his IRA to Trust Y. Trust Y is a conduit trust, requiring all IRA distributions received by the trustee be distributed to A's wife, B for her lifetime. The IRA is making minimum distributions based on B's life expectancy. Trust Y further provides that upon the death of B, all remaining trust assets are to be distributed to Charity. Since Trust Y is a conduit trust, Charity is ignored for purposes of determining who is the beneficiary with the shortest life expectancy and whether a person who is not an individual is a beneficiary. When a spouse is a sole IRA beneficiary, the spouse's life expectancy is determined by the recalculation method. The IRA cannot be entirely distributed during B's lifetime if only the required minimum distribution is taken by the trustee. Therefore, a non-individual, Charity is guaranteed to receive some the IRA, yet Charity is not counted.

As another example, assume F dies naming Trust Z as sole beneficiary of F's IRA. Trust Z provides that F's child, C is to receive income and principal of Trust Z for C's support, health and maintenance in the discretion of the trustee until C reaches age 21. When C reaches age 21, the remaining assets of Trust Z are distributed outright to C. Trust Z further provides that if C dies before age 21, the remaining assets are to be distributed to Charity. At F's death, C is five years old. The likelihood that

¹⁴ In fact, due to the compressed income tax rates applicable to trusts, it is likely accumulation trusts which accumulate IRA distributions generate more tax revenue than conduit trusts.

a five-year-old will die before age 21 is 0.9%, meaning there is a 99.1% chance Charity will receive no benefit of the IRA.¹⁵ However, following a literal interpretation of the Final Regulations and PLR 200228025, Charity is counted as a trust beneficiary, and thus Trust Z does not qualify as a designated beneficiary. C is denied an ADP based on C's life expectancy.

D. Guidance Beyond Conduit Trusts Is Needed

Conduit trusts are a safer harbor, but impractical for most taxpayers. In many cases, conduit trusts are directly opposed to the purposes of using a trust. The practical difference between a conduit trust and an accumulation trust is minimal, yet peculiar results are possible that seem inconsistent with the intent of the Final Regulations.

Since conduit trusts are not a practical option for many taxpayers, Treas. Reg. §1.401(a)(9)-5, A-7 needs to be modified to clarify which trust beneficiaries are counted for purposes of determining whether an IRA has a designated beneficiary and the identity of the oldest beneficiary for purposes of determining required minimum distributions.

IV. PROPOSED ACTION

Treas. Reg. §1.401(a)(9)-5, A-7 should be changed to delineate more clearly those contingent beneficiaries that are counted for purposes of determining whether an IRA has a designated beneficiary and the identity of the beneficiary with the shortest life expectancy. Certainly Treas. Reg. §1.401(a)(9)-5, A-7 applies to all situations in which there are multiple beneficiaries, and thus due consideration of these non-trust situations must also be addressed.

A. Provide Additional Examples

At a minimum, Treas. Reg. §1.401(a)(9)-5, A-7 (c)(3) should be modified to include examples that tie to real world trust drafting situations. It would be very helpful to have examples that illustrate (i) who is the beneficiary with the shortest life expectancy, and (ii) whether a person who is not an individual is a beneficiary in the following trust examples:

¹⁵ Determined with NumberCruncher version 2002.02 using a male age five, published by Stephan R. Leimberg and Robert T. LeClair.

Example A: Settlor A names Trust Z as beneficiary of A's IRA. At A's death, the trustee of Trust Z has the discretion to distribute income and principal to A's child, C for his health education and maintenance for C's lifetime. Trust Z allows for accumulations of distributions from A's IRA. Upon C's death, the remaining trust assets are to be divided into equal shares for C's children, D and E. If D and E are not then living, the remaining assets of Trust Z are to be distributed to Charity S. Trust Z otherwise qualifies as a look-through trust.

Example B: Settlor A names Trust Z as beneficiary of A's IRA. At A's death, the trustee of Trust Z has the discretion to distribute income and principal to A's child, C for his health education and maintenance for C's lifetime. Trust Z allows for accumulations of distributions from A's IRA. Upon C's death, the remaining trust assets are to be divided into equal shares for C's children, D and E. Under state law, if D and E do not survive C, the remaining assets of Trust Z are to be distributed to A's estate. Trust Z otherwise qualifies as a look-through trust.

B. Beyond Mere Examples

Employees, plan administrators and their advisors will invariably encounter situations that do not specifically fall within provided examples. Thus, one or more bright-line tests should be provided in Treas. Reg. §1.401(a)(9)-5, A-7 that can be used to clearly determine which beneficiaries are counted and which are ignored for purposes of determining required minimum distributions.

Since the death contingency of the 1987 and 2001 Proposed Regulations was removed, at least in name, the assumption is made that the death contingency bright-line test is not desirable to the Treasury Department. There are several other bright-line tests that can be employed, such as putting look-through accumulation trusts on par with conduit trusts, a 5% probability rule and a rule based on survivorship and specific ages.

1. *Safe Harbor Accumulation Trust*

Treas. Reg. §1.401(a)(9)-5, A-7 could be modified in such a way as to put qualifying accumulation trusts on par with conduit trusts, that is, create safe harbor accumulation trusts. For example, Treas.

Reg. §1.401(a)(9)-5, A-7(c)(1) could provide an additional example as follows: if a beneficiary has a right to income and principal of a trust named as beneficiary of an employee's IRA, whether or not such income or principal can be accumulated for the benefit of such beneficiary, during that beneficiary's life or until a specified age at which time such beneficiary receives all trust assets, only that beneficiary shall be considered to be a beneficiary for purposes of determining whether a person other than an individual is designated as a beneficiary (resulting in the employee being treated as having no designated beneficiary under the rules of A-3 of §1.401(a)(9)-4) and which designated beneficiary has the shortest life expectancy under paragraph (a) of this A-7. Such a trust, referred to herein as a "safe harbor accumulation trust", would provide a safe harbor for those trusts in which a primary beneficiary has a right to all trust income and principal for life or until a specified age.

Another example of a safe harbor accumulation trust could be as follows: if a beneficiary has a right to income and principal of an employee's IRA during that beneficiary's life or until a specified age at which time such beneficiary receives all trust assets (the "primary beneficiary"), and such trust has a named remainder beneficiary who takes in the event the primary beneficiary dies before trust termination, then only the primary beneficiary and the remainder beneficiary shall be considered to be a beneficiary for purposes of determining whether a person other than an individual is designated as a beneficiary (resulting in the employee being treated as having no designated beneficiary under the rules of A-3 of §1.401(a)(9)-4) and which designated beneficiary has the shortest life expectancy under paragraph (a) of this A-7. Such a result shall apply whether or not the income or principal of such trust can be accumulated for the benefit of the primary beneficiary.

In order to avoid abuses, such as granting a beneficiary with a shorter life expectancy a right of withdrawal for a number of years, the examples could further provide that any beneficiary with a right of withdrawal is also counted.

Taking either of these approaches to a safe harbor accumulation trust would assure look through accumulation trusts as viable options for employees who name trusts as beneficiaries of IRAs. Many employee's existing estate plans would operate as they expect, avoiding the need to revisit their advisor and incur substantial fees. It would also clarify

much of the confusion surrounding Treas. Reg. §1.401(a)(9)-5, A-7. Finally, this approach would eliminate most cases in which conduit trusts and accumulation trusts produce results contrary to the apparent intentions of the Final Regulations.

2. *The 5% Test*

An alternate bright-line test could be a 5% test. Treas. Reg. §1.401(a)(9)-5, A-7 could be modified to provide that those beneficiaries who have a 5% or less chance of receiving any benefit from the trust are ignored for purposes of determining whether an IRA has a designated beneficiary and the identity of the oldest beneficiary for purposes of determining required minimum distributions. This proposal is referred to herein as the “5% Test”.

A 5% test has been incorporated by Congress and the Treasury Department in many other tax areas.¹⁶ The 5% Test would provide clarity to look through accumulation trusts and give taxpayers, plan administrators and their advisors certainty as to how minimum distributions will be computed when naming a particular trust as beneficiary of an IRA.

The average plan administrator or estate planner may have trouble consistently determining which trust beneficiaries meet a 5% Test and which trust beneficiaries fail. Regardless, a 5% Test would provide much more clarity than currently exists and provide taxpayers and their advisors a bright-line test to make sure they are following the required minimum distributions rules.

3. *The Specific Age Test*

Treas. Reg. §1.401(a)(9)-5, A-7 could also be amended to provide so that beneficiaries who would receive IRA benefits only if another beneficiary dies before attaining age 46 are ignored for purposes of determining whether an IRA has a designated beneficiary and the identity of

¹⁶ See for example the eligibility for a deferred “required beginning date” of § 401(a)(9)(C)(ii), estate inclusion under § 2037(c), qualification of charitable deductions under § 664 and Rev. Rul. 77-374 (1977-2 C.B. 329), and the income taxation of a trust grantor under § 673(a) when the grantor has a reversionary interest worth more than 5% of the total trust value.

the oldest beneficiary for purposes of determining required minimum distributions.¹⁷ This test is referred to herein as the “Specific Age Test”.

As an example, employee J names Trust Y as beneficiary of J’s IRA. Trust Y provides for discretionary distributions of income and principal to J’s child C1 until C1 attains age 46. When C1 attains age 46, the remaining assets of Trust Y are distributed to C1 outright. If C1 dies before age 46, the trust assets are held in trust for J’s other child, C2 until C2 attains age 46, at which time the remaining assets of Trust Y are distributed outright to C2. If C2 dies before age 46, the assets of Trust Y pass to Charity. The trustee of Trust Y may accumulate IRS distributions in Trust Y. Under the Specific Age Test, Charity is not counted because Charity only takes if another beneficiary, C2, dies before attaining age 46.

The Specific Age Test offers similar benefits to the 5% Test, but is more accessible to the average plan administrator and estate planner. The problem is that depending on the age chosen, the result can be underinclusive, omitting some cases where contingent beneficiaries should be ignored. Further, the Specific Age Test may not match the ages already selected and being used in existing estate plans.

V. CONCLUSION

Since 1987, accumulation trusts have been permitted look through trusts. If the Final Regulations intended to exclude the look through of accumulation trusts, certain provisions of the Final Regulations would be superfluous.¹⁸ Therefore, most taxpayers and practitioners believe accumulation trusts are still available to achieve the life expectancy payout method and ignore certain beneficiaries when determining the beneficiary shortest life expectancy. More guidance from the Treasury Department is needed to clarify which beneficiaries are counted for purposes of determining required minimum distributions from IRAs. The guidance should confirm employer, advisor and plan administrator expectations and confirm that estate plans established in reliance on the 1987 and 2001 Proposed Regulations continue to achieve the planned results.

¹⁷ Similar to the rule Congress adopted under § 2632(c)(3)(B)(i) regarding allocation of GST exemption to a trust if more than 25% of the trust is to be distributed outright to non-skip persons before the age of 46.

¹⁸ Treas. Reg. §1.401(a)(9)-5, A-7(c)(3), Example 1 would be superfluous as Trust P allows for accumulations of IRA distributions.