NAEPC
Journal
of Estate & Tax Planning

Click here to view Issue 33

# Drafting Income Tax-Sensitive Trusts Under the New Tax Laws

By

James G. Blase. CPA, JD, LLM

and

Ryan G. Polley, JD

Blase & Associates, LLC

St. Louis, Missouri

The disparate federal income tax treatment between trusts and individuals, that has existed since 1986, has grown even more pronounced than it was prior to the passage of the 2017 and 2019 year-end tax laws. This article will examine the problems which currently face us and will propose solutions to these problems.

Part I: Impact of the 2017 Year-End Tax Changes

As a result of the 2017 year-end tax changes, structuring trusts for spouses, descendants and other beneficiaries, in a fashion which minimizes the aggregate federal income tax liability for the trust and its beneficiaries, became more important than ever. Discussed below are some of the reasons why:

In 2020 individuals can effectively exclude the first $12,400 ($24,800, if married) of income, whereas trusts can effectively exclude only the first $100 ($300, if a simple trust). Individuals are also taxed at significantly lower ordinary income tax rates than trusts, at the same level of taxable income. This gap in income tax treatment has widened considerably as a result of the 2017 year-end tax changes.

For example, an individual with $172,925 of interest income, and no deductions, paid $32,748.50 of federal income tax in 2019, while married couples with the same level of interest income paid only $24,392.50 of federal income tax in 2019. Complex trusts with the same amount of interest income, and no deductions (including the distribution deduction), on the other hand, paid $68,389.90 of federal income tax in 2019 [$62,303.25 regular tax + $6,086.65 net investment income tax]. These differences under the new tax law are obviously staggering. A trust pays well over twice as much federal income tax as a single individual with the same amount of interest income, and almost three times as much as a married couple with the same amount.

For comparison purposes, before the 2017 year-end tax changes a single individual with the same amount of interest income paid $38,488.75 of federal tax in 2017, and a married couple paid $29,508.75. A complex trust paid $73,714 in 2017. Thus, utilizing the above example, as a result of the 2017 year-end tax changes the single individual's federal taxes went down 17.5% while the married couple's federal taxes went down 21%. Complex trusts, on the other hand, saw their taxes go down by only 7.8%. Simply put, this means that the relative disparity between trust income tax treatment and individual income tax treatment grew even greater as a result of the 2017 year-end tax changes. If the same trust income were instead spread between or among two or more children beneficiaries of the trust, the disparity between the trust and individual income tax brackets would become even more apparent.

Individuals also enjoy a substantial benefit over trusts when it comes to the income taxation of capital gains and qualified dividends. A trust may only have $2,900 (in 2020) of taxable income and still be taxed at 0% on its capital gains and qualified dividends. The comparable level for single individuals is almost 14 times higher, or $40,000 (in 2020), which, when combined with the single beneficiary's $12,400 standard deduction, means that a single individual (including a minor child) could have up to $52,400 in qualified dividends, annually, without paying any federal income tax, subject to the potential application of the Kiddie Tax rules. A trust with a like amount of qualified dividend income, on the other hand, would pay approximately $10,750 in income tax (applying 2018 rates), including approximately $1,500 in net investment income tax. The same annual amount compounded at 4%, over 20 years, would equal approximately $320,000, which can certainly help pay for college.

A similar but more dramatic result would occur if there were two or more beneficiaries of the trust. As long as each beneficiary's taxable income was less than $52,400, they would each pay no federal income tax on the capital gains and qualified dividends. Thus, there could be over $150,000 of qualified dividends and capital gains inside of a trust, which if taxed equally to three single individual beneficiaries, with no independent income of their own, would result in $0 federal income tax. The annual federal income tax to the trust, on the other hand, including the net investment income tax, would be approximately $34,000 (applying 2018 tax rates). Compounded annually at 4% over 20 years again, this annual income tax difference would equal over $1 million! Similar larger tax gaps between trusts and individuals occur at the 15% and 20% capital gain rates, as well as at ordinary income tax rates.

Trusts also pay the 3.8% net investment income tax on the lesser of undistributed net investment income or adjusted gross income in excess of $12,750 (for 2019); a single individual, on the other hand, needs to have net investment income or modified AGI in excess of $200,000 ($250,000 for married couples) before he or she will pay the 3.8% tax.

The singular tax benefit trusts now maintain over individuals is the deduction for trustee fees, trust tax return preparation fees, and other expenses uniquely related to trusts. Trusts are entitled to these deductions whereas individuals are not.

Given that most income generated by trusts is passive income, it is extremely important for CPAs, estate planning attorneys, trustees and their financial advisors to be aware of the significant disparity in the federal income taxation of the various types of passive income taxable to trusts versus individuals, whether that be in tax planning, document preparation, encroachment decisions, or investment decisions. The client's professional team also needs to be ever-cognizant of the non-tax advantages of retaining income and capital gains inside trusts when it comes to estate tax protection, divorce protection, creditor protection, and the various protections which are normally associated with underage and otherwise financially immature beneficiaries. These significant advantages of trusts would all be negated to the extent the trustee chooses to distribute the income (including qualified plan and IRA receipts) and capital gains to the beneficiary in an effort to plan around the severely compressed trust income and capital gains tax brackets.

It would be a simple matter to distribute all of the current income of the trust to the trust beneficiaries, in order to avoid the compressed trust income tax rates. In limited circumstances (e.g., by allocating capital gains to trust accounting income in the trust document), it might also be possible to distribute the trust's capital gains to the beneficiaries, in order to avoid the higher capital gains rates typically applicable to trusts, as well as the 3.8% net investment income tax. The problem is that few clients want these automatic trust distributions to their children or other heirs to occur. For the parents of minors and other young children and adults, the issue is obvious. Parents of young children and adults do not want significant automatic annual distributions to the children, or to the guardian or conservator for the children, to be made. Parents of older children are more concerned with issues of divorce protection, creditor protection, and estate tax minimization (including state death taxes) for their children. The automatic distribution of trust income and capital gains to the children ignores this legitimate parental concern. Parents of special needs children also obviously do not want the trust income to be paid to the children.

Drafting Solutions

Here are some planning thoughts which the trustee or advisor may wish to consider to assist clients in responding to their predicament - the challenge of achieving significant income tax savings while also preserving the non-tax purposes of the trust.

Use of Section 678 Withdrawal Power Over Trust Income

For new trusts, drafting an IRC Section 678(a)(1) withdrawal power over trust accounting income into the trust (other than a simple trust), in order to tax the trust beneficiary on all trust taxable income, is not only permissible in the tax law, but, for all the income-tax-saving reasons outlined above, is usually advisable. [*See* Regs. §§1.678(a)-1, 1.671-3(c), 1.677(a)-1(g), Ex. 2.] This power should be coupled with a direction in the trust instrument to allocate all capital gains and IRA, etc., receipts to trust accounting income, which is also specifically permitted in the Regulations [Regs. §1.643(b)-1.], as well as with a power in the trustee to fully or partially suspend the beneficiary's future withdrawal power in appropriate situations, e.g., immature or unwise use of withdrawn funds by the beneficiary, lawsuits, divorce, college financial aid qualification reasons, or, as discussed below, for the purpose of minimizing overall income taxes to the trust and its beneficiaries.

Except in the case where IRAs, etc., are distributable to the trust (which situation is covered in Part 2 of this article), it may even be possible, and make sense in some circumstances, to add a Section 678 withdrawal power to a "special" or "supplemental" needs trust, e.g., by giving the withdrawal power to a sibling or siblings in a modest income tax bracket. If so, the sibling's withdrawal power would again want to be coupled with an ability in the trustee to suspend the same, if the sibling is not acting in the special needs child's best interests. (See the additional discussion on trustee suspension powers, below.)

Note that if the withdrawal power holder needs funds to pay the income tax attributable to his or withdrawal right, he or she merely may exercise the withdrawal power to the extent so necessary. An alternative would be to allow an independent trustee to pay these taxes, either directly or indirectly by reimbursing the beneficiary.

Some may argue that a minor's legal guardian has a fiduciary duty to exercise the Section 678 withdrawal power on behalf of the ward/beneficiary, and that therefore employment of the power of withdrawal in the case of minor beneficiaries could turn out to defeat the parents' desire that their children do not receive substantial sums at age 18. Is this a sound argument? Would a legal guardian, knowing that any amounts not withdrawn on the beneficiary's behalf will remain in a creditor-protected trust held exclusively for the ward's benefit, and that the ward will eventually control this trust at a designated age, be acting in the ward's best interest if he or she chose to exercise the withdrawal power and deposit the withdrawn funds in an unprotected guardianship or conservatorship account for the ward? Assume the ward is later involved in a major automobile accident, and the guardianship or conservatorship estate is exhausted to satisfy a claim against the ward. Could the guardian then be surcharged for foolishly and needlessly withdrawing the funds from the protected trust? The point is self-evident.

Some may also argue that, under IRC Section 678(a)(2) and IRS private letter rulings, when the beneficiary's withdrawal power lapses each year, the beneficiary continues to be taxed on an ever-increasing portion of the trust's income, including capital gains. The problem with this argument (aside from the fact that it is really just an argument in favor of lower income taxes, in most instances) is that it flies in the face of the Internal Revenue Code itself, as the *withdrawal power holder* has not "partially released or otherwise modified" the power. The power lapses by the terms of the trust, not by any affirmative "release" or "modification" *on the part of the beneficiary withdrawal power holder*, which is what Section 678(a)(2) requires. In any event, because it is now normally desired that all of the trust's taxable income be taxable to the current beneficiary anyway, this debate is now largely moot.

Because the beneficiary's withdrawal right is designed to fully or partially (i.e., subject to a "hanging power") lapse at the end of each year, i.e., to the extent of 5% of the value of the trust each year, in order avoid annual taxable gifts under IRC Section 2514(e), will the lapsed amount be accessible to the beneficiary's future creditors? In most states, and under the Uniform Trust Code, the beneficiary's annual power (including, presumably, any "hanging power") is not protected, but the annual lapses of the withdrawal rights, are. [The American College of Trust & Estate Counsel, or ACTEC, has an excellent web link on this topic.] In the balance of the states which do not protect the annual lapse of the withdrawal right from the beneficiary's creditors the question must be asked: Who is the real "creditor" here, when the alternative to "Section 678 planning" is to pay much higher income taxes to the IRS? While the beneficiaries of a trust can protect themselves against many types of potential future lawsuits with umbrella liability insurance, these policies will obviously be ineffective as against the excessive income taxes the trust will most certainly owe the IRS.

Use of Trustee Suspension Power

With the current and future uncertainty in the tax law, with the uncertainty in the trust's and beneficiary's respective tax situations, and with the above-described varied treatment of the Section 678 withdrawal power for creditor rights purposes, the Section 678 power needs to be drafted in a flexible fashion, so that it can adapt to various and changing circumstances. One way of accomplishing this is to allow an "independent trustee" (meaning one with no beneficial interest in the trust) the opportunity to either (i) annually suspend (and restore), broaden and/or alter *future* withdrawal powers, in whole or in part, prior to January 1 of the next tax year, or (ii) amend the trust's terms to achieve the lowest combined current income tax liability for the trust and its beneficiaries, but without affecting *existing* withdrawal powers. [*See* Blattmachr on Income Taxation of Estates and Trusts §5.5.1 (Seventeenth Edition 2018).] The provision authorizing these independent trustee actions should be carefully limited to ensure maximum income tax deferral for IRAs, etc., which may become payable to the trust. (See the discussion in Part 2, below.)

Another reason for the needed flexibility is the above-alluded-to manner in which certain trust expenses are treated for trust versus individual income tax purposes. The unbundled portion of trustee fees not attributable to investment advisory services, for example, may be deductible for trust income tax purposes, under the current tax law, but not deductible for individual income tax purposes. Under the IRS Regulations, an allocable portion of these types of fees would be applied to the beneficiary of the Section 678 withdrawal power, and as a consequence would no longer be deductible. [*See* Regs. §§1.678(a)-1, 1.671-3(c), 1.677(a)-1(g), Ex. 2.] The trustee may thus find itself in a situation where the federal marginal income tax rate applicable to the individual beneficiary is much lower than the federal marginal income tax rate applicable to the trust, but making use of the individual's income tax rate would eliminate a potentially significant annual income tax deduction.

Take, for example, a $2 million trust with a 1% annual trustee fee on the first $1 million of assets and a 0.75% fee on the next million. The total annual trustee fee would be $17,500. Assume also that no portion of this fee is allocable to tax-exempt income. If the deduction for this fee is lost by allocating it to the individual beneficiary under a Section 678 power, the negative annual income tax effect could be as much as $6,500. If the individual beneficiary is at least that much ahead by having the trust income and capital gains taxed to him or her, versus the trust, this may be fine; but if the overall savings is less than this, suspension of the beneficiary's Section 678 withdrawal power by an independent trustee may be in order. In most cases this will be easy enough to do, because the trust would likely already have an independent trustee in place. Note also that, after the suspension, the independent trustee will still retain the power to make IRC Sections 661/662 distributions to the individual beneficiary with the "after tax deduction income," the negative, of course, being the loss of the non-tax advantages for retaining assets in trust.

Suspension or alteration of the individual beneficiary's future withdrawal powers may likewise be advantageous when the trust would otherwise be entitled to a significant tax deduction for state taxes paid (if state capital gains taxes would otherwise be payable by the trust as a result of a large capital gain inside the trust), at a time when the individual beneficiary is already benefiting from a similar state tax deduction. Suspending the individual beneficiary's future Section 678 withdrawal power may make it possible to, in effect, "double up" on the current $10,000 annual ceiling on the state income tax deduction and achieve an aggregate deduction of as much as $20,000. As in the case of the trustee fee deduction, this technique could then be coupled with an IRC Sections 661/662 distribution to the individual beneficiary of the "after tax deduction income." Again, the aggregate tax savings of using the suspension power in this situation should be balanced against the non-tax reasons for retaining the income in the trust.

Suspension of the individual beneficiary's future Section 678 withdrawal power may also make sense if the individual beneficiary is already in a high tax bracket, or if the individual beneficiary is subject to the so-called "Kiddie Tax" in a particular year. However, before making this decision, the independent trustee should bear in mind that this type of individual beneficiary might also be benefiting on the estate tax side, by personally paying the income taxes attributable to an estate or generation-skipping transfer tax exempt trust's income. If the decision to suspend is made here, remember that the independent trustee can always restore the beneficiary's withdrawal power in the future, in full or in part, if and when changed circumstances dictate.

In certain situations it may make sense for an independent trustee to only partially suspend a beneficiary's future Section 678 withdrawal power. For example, if the trust does not have any significant tax deductions which would be lost, it might be beneficial to suspend the beneficiary's withdrawal power only over an amount equal to the level at which the trust reaches the maximum income tax bracket (e.g., $12,951 in 2020), or to some other lower tax bracket level. In so doing, the trustee may also elect to limit the suspension to income items other than qualified dividends and capital gains, first, so that the beneficiary may avail himself or herself of the significantly larger 0% tax bracket amount for these items, while also avoiding the 3.8% tax on net investment income.

Bear in mind, however, that the tax benefits of this "partial" suspension will be limited by the fact that the general effective tax rate on the compressed lower brackets of the trust is over 24%, a rate which does not kick in for single individuals until income levels of almost $98,000 (in 2020, including the $12,400 standard deduction). [The married couple numbers are twice these figures.] The next tax bracket of 32% is not reached until the single individual has over $175,700 in income, including the $12,400 standard deduction. [Again, the married couple numbers are twice these figures.] Thus, unless the beneficiary has a significant taxable income, utilizing this partial suspension technique will normally be tax neutral, at best. In fact, and as alluded to above, subject to the potential application of the Kiddie Tax rules, if the beneficiary has little or no separate income, utilizing the suspension technique may effectively cause some loss of the 0% tax rate on qualified dividends and capital gains to a single beneficiary with income (including the $12,400 standard deduction) of $52,400 or less in 2020.

As alluded to above, perhaps the most important reason for including a trustee suspension power in the trust is that it allows the trustee to maintain some control over the beneficiary's "non-tax situation." This is what concerns most of our parent clients the most. As just some of the potential examples, the trustee might suspend the beneficiary's future withdrawal power (i) because of the immature or unwise use of funds the beneficiary is withdrawing from the trust, (ii) to motivate the beneficiary to take a particular action (e.g., go to college, or get a job), (iii) because the beneficiary is getting a divorce, (iv) because the beneficiary is involved in a lawsuit, or (v) because the beneficiary is attempting to qualify for college financial aid and a withdrawal right would hinder these efforts.

Due to the multitude and potential complexity of the issues involved, the trust document should exonerate the independent trustee for any decision or non-decision relative to the trustee's suspension power. The trustee should also be reminded that, in order to clearly comply with the IRC Section 678(a)(1) requirements, the suspension power may only be exercised effective January 1 of the following tax year. This will typically require some level of annual dialogue between or among the trust's CPA, attorney, trustee and/or investment advisor.

<u>Trust Income Which Exceeds the Section 2514(e) Limitation</u>

Assume that a significant portion of the trust accounting income (including capital gains and IRA, etc., receipts allocated to trust accounting income) would exceed the Section 2514(e) 5% limitation. Is there a solution to this problem which will cause the beneficiary to be taxed on the income, but without the potential of causing a taxable lapse under either IRC Section 2041(b)(2) or 2514(e)?

There is a 9th Circuit Court of Appeals decision, *Fish v. United States*, 432 F.2d 1278 (9th Cir. 1970), which, although incorrectly decided, nevertheless stands for the proposition that the "5 and 5" limitation in the case of a beneficiary's withdrawal power over income can *only* be based on the current income of the trust as the denominator. It cannot be based on the entire value of the trust, even if the trustee is expressly granted the power, under the trust instrument, to use any assets of the trust in order to satisfy the beneficiary's exercise of the withdrawal power. The court's theory was that, because the beneficiary possessed no withdrawal power over trust principal, the latter could not be included in the "5% denominator," despite the clear language of the Internal Revenue Code to the contrary if the trustee was permitted to use any asset of the trust to satisfy the exercise of the beneficiary's withdrawal power.

Therefore, if we wish to "stay clear" of *Fish, and* simultaneously cause all of the trust's current income (including capital gains and IRA, etc., distributions) to be taxed to the trust's beneficiary, and not to the trust, we need to utilize the following three-step process:

Step 1: Provide in the trust document that the trust's current beneficiary has a right to withdraw all of the current income of the trust, including, as defined in the trust document, all capital gains and IRA, etc., distributions.

Step 2: Provide in the trust document that the beneficiary's withdrawal power over this trust income lapses at the end of each year, but only to the extent it will not constitute a release under either IRC Section 2041(b)(2) or 2514(e), and make clear in the trust document that the trustee can use any of the trust's assets, whether current income or principal, to satisfy the exercise of the withdrawal power by the beneficiary, including assets which may be payable to the trust over time, such as IRAs. [Note that the "deemed release" amount will therefore vary, depending on whether or not you choose to follow the 9th Circuit's decision in *Fish*.] Because of the hanging power, even if *Fish* applied there would be no IRC Section 2041(b)(2) or 2514(e) lapse issue.

Step 3: The current income not withdrawn by the beneficiary during the calendar year is added to the principal of the trust, and the current beneficiary retains an annual power to withdraw from the principal of the trust an amount equal to the trust's previous current income in which the beneficiary's withdrawal power did not lapse at the end of any previous calendar year pursuant to Step 2. This subsequent power of withdrawal over principal will thereupon lapse at the end of each succeeding calendar year, but again only to the extent it will not constitute a release under either IRC Section 2041(b)(2) or 2514(e). The trustee is given the power to use all or any portion of the trust's assets to satisfy the exercise of the withdrawal power by the beneficiary under this Step 3, other than current trust accounting income, including assets which may be payable to the trust over time, such as IRAs. Because the trust document now clearly bestows upon the beneficiary a right to withdraw trust principal in Step 3, the basis of the 9th Circuit's decision in *Fish* no longer exists.

If the beneficiary desires to accelerate the lapsing process under this 3-step plan, but without adding to the value of the beneficiary's assets, the beneficiary need merely exercise the beneficiary's power of withdrawal to pay the income taxes attributable to the Section 678 power and/or to pay other living expenses.

Sample Form

Here is a sample form which implements these "Section 678" drafting recommendations:

Section 1. Distribution of Income and Principal During Lifetime of Beneficiary

1.1 Subject to the remaining provisions of this subsection 1.1, during the beneficiary's lifetime the beneficiary (including any legal representative acting on behalf of the beneficiary if the beneficiary is under a legal incapacity) shall have the annual noncumulative power to withdraw all or any portion of the trust accounting income on or before December 31 of the calendar year (or on the date of the beneficiary's death, if earlier); PROVIDED, HOWEVER, that (i) the foregoing power of withdrawal shall not extend to the portion of the trust accounting income which, for the calendar year, would be exempt from federal income tax, and (ii) if Section 2041(b)(2) and/or 2514(e) of the Internal Revenue Code, or any successor sections thereto, is/are in effect during the calendar year, the beneficiary's power of withdrawal under this subsection 1.1 shall lapse at the end of the calendar year (or on the date of the beneficiary's death, if earlier) to the extent the same shall not constitute a release of a general power of appointment by the beneficiary pursuant to the provisions of either or both Section 2041(b)(2) and/or 2514(e) of the Internal Revenue Code, or any successor sections thereto in effect at the time of the lapse, after factoring in all other lapsed powers of withdrawal of the beneficiary other than pursuant to the provisions of subsection 1.2, below. The portion of the trust accounting income for the calendar year subject to the beneficiary's foregoing power of withdrawal which is not withdrawn by the beneficiary (including by any legal representative acting on behalf of the beneficiary if the beneficiary is under a legal incapacity) during the calendar year and in which the beneficiary's withdrawal power has not lapsed pursuant to the foregoing provisions of this subsection 1.1 shall accumulate and continue to be subject to a power of withdrawal in the beneficiary (including any legal representative acting on behalf of the beneficiary if the beneficiary is under a legal incapacity) pursuant to the provisions of subsection 1.2, below. Any such withdrawable trust accounting income which is not withdrawn by the beneficiary (or by a legal representative acting on behalf of the beneficiary if the beneficiary is under a legal disability) by the end of any calendar year (or by the time of the beneficiary's death, if earlier) shall be added to the principal of the trust estate. **[ATTORNEY DRAFTING NOTE: MAY NOT WANT TO USE BENEFICIARY INCOME WITHDRAWAL RIGHTS WHEN: (1) SECOND SPOUSE, OR (2) HIGH NET WORTH CLIENT AND NO TAX BENEFIT FOR SUCH POWER OVER NON-GST TAX-EXEMPT TRUST.]**

1.2 Subject to the remaining provisions of this subsection 1.2, during the beneficiary's lifetime the beneficiary (including any legal representative acting on behalf of the beneficiary if the beneficiary is under a legal incapacity) shall have the annual cumulative power to withdraw from the principal of the trust estate an amount equal to all or any portion of the trust accounting income for all previous years of the trust which has not previously been withdrawn by the beneficiary (either pursuant to the provisions of subsection 1.1, above, or this subsection 1.2) and over which the beneficiary's withdrawal power has not previously lapsed either pursuant to the provisions of subsection 1.1, above, or this subsection 1.2. The beneficiary's power of withdrawal under this subsection 1.2 shall lapse at the end of the calendar year (or on the date of the beneficiary's death, if earlier) to the extent the same shall not constitute a release of a general power of appointment by the beneficiary pursuant to the provisions of either or both Section 2041(b)(2) and/or 2514(e) of the Internal Revenue Code, or any successor sections thereto in effect at the time of the lapse, after factoring in all other lapsed powers of withdrawal of the beneficiary during the same calendar year pursuant to the provisions of either or both Section 2041(b)(2) and/or 2514(e) of the Internal Revenue Code, or any successor sections thereto in effect at the time of the lapse, including any lapse pursuant to the provisions of subsection 1.1, above. The portion of the beneficiary's withdrawal power under this subsection 1.2 which is not exercised by the beneficiary during the calendar year and which has not lapsed during the calendar year pursuant to the foregoing provisions of this subsection 1.2 shall continue to be withdrawable by the beneficiary (including any legal representative acting on behalf of the beneficiary if the beneficiary is under a legal incapacity) pursuant to the provisions of this subsection 1.2.

1.3 For purposes of this Section 1, the term "trust accounting income" shall include all retirement assets (as defined in ARTICLE __, below) paid to the trust during the year, regardless of whether all of said retirement assets paid to the trust during the year are otherwise considered trust accounting income, and the principal of the trust shall include the underlying value of all retirement assets (as defined in ARTICLE __, below) and other assets which are payable to the trust over time and not yet paid to the trust. Satisfactions of any right of withdrawal of the beneficiary pursuant to the provisions of this subsection 1.1 and 1.2, above, must be made in cash, although the trustee may liquidate any asset of the trust (including but not limited to by withdrawing retirement assets [as defined in ARTICLE __, below] and other assets which are payable to the trust over time and not yet paid to the trust) in order to generate said cash; PROVIDED, HOWEVER, that the trustee may not utilize current trust accounting income to satisfy the beneficiary's right of withdrawal under subsection 1.2, above. The trustee other than a trustee having any beneficial interest in the trust (other than solely as a contingent taker under ARTICLE __, below) may, in the sole and absolute discretion of said trustee, suspend, expand and/or alter the beneficiary's withdrawal power under subsection 1.1 and/or 1.2, above, in whole or in part, by instrument in writing executed by said trustee before January 1 of the calendar year in which such withdrawal power would otherwise exist. Reasons for such suspension, expansion and/or alteration may include, but shall not be limited to, overall tax savings for the trust and its beneficiaries (including remainder beneficiaries), creditor protection for the beneficiary, and unwise or immature use of withdrawn funds by the beneficiary. In the event the beneficiary shall have the beneficiary's aforesaid power of withdrawal suspended, in whole or in part, the trustee other than a trustee having any beneficial interest in the trust (other than solely as a contingent taker under ARTICLE __, below) may also, in the sole and absolute discretion of said trustee, restore the beneficiary's withdrawal power under subsection 1.1 and/or 1.2, above, in whole or in part, at any time, by instrument in writing executed by said trustee. The trustee shall be exonerated from any liability for any decision or non-decision under this subsection.

1.4 The trustee may, in the trustee's sole discretion, distribute, use or apply so much of the income and principal of the trust estate (which is not withdrawable by the beneficiary or by the beneficiary's legal representative pursuant to the provisions of subsection 1.1 or 1.2, above) as the trustee may deem necessary to provide for the maintenance, support, health care and education of the beneficiary, in the beneficiary's accustomed manner of living. In addition, the trustee may, in the trustee's sole discretion, distribute, use or apply the income and principal of the trust estate (which is not withdrawable by the beneficiary or by the beneficiary's legal representative pursuant to the provisions of subsection 1.1 or 1.2, above) as the trustee may deem necessary for the maintenance, support, health care and education of any descendant of the beneficiary; PROVIDED, HOWEVER, that (i) the needs of the beneficiary as specified above shall be the primary concern of the trustee, and (ii) neither the income nor principal of the trust may be used to limit, relieve or otherwise discharge, in whole or in part, the legal obligation of any individual to support and maintain any other individual. In determining the amounts to be distributed, used or applied for the beneficiary's descendants, the trustee shall not be required to treat each of such persons equally but shall be governed more by the particular needs and interests of each of them. The trustee other than the beneficiary and other than a trustee designated by the beneficiary who is "related or subordinate" to the beneficiary within the meaning of current Section 672(c) of the Internal Revenue Code, or any successor section thereto (substituting "the beneficiary" for "the grantor" in said Section), may, in such trustee's sole and absolute discretion, utilize the income and principal of the trust estate (which is not withdrawable by the beneficiary or by the beneficiary's legal representative pursuant to the provisions of subsection 1.1 or 1.2, above) for the purpose of purpose of paying all or any portion of the beneficiary's income taxes, directly, or indirectly by reimbursing the beneficiary for any income taxes paid by the beneficiary, including but not limited to income tax liability accruing to the beneficiary as a result of the beneficiary's power of withdrawal under subsection 1.1 or 1.2, above; PROVIDED, HOWEVER, that the trustee shall not possess the discretionary power described in this sentence if, as a consequence of possessing said power, the beneficiary is deemed to possess the same power for federal or state estate tax, gift tax, generation-skipping transfer tax, inheritance tax or other transfer tax purposes.

1.5 The trustee shall be entitled to rely on the advice of legal counsel with respect to any matter under this Section 1; PROVIDED, HOWEVER, that if said legal counsel's opinion is subsequently determined to be invalid as applied to this subsection, either as a result of a subsequently passed federal or state law, or a subsequently promulgated regulation or published ruling, or as a result of judicial decision, the matter shall be determined based on such subsequent development and not in accordance with said legal counsel's opinion.

The following additional clauses are designed to achieve income tax basis step-up on the remaining assets of the trust at the death of the beneficiary, while also minimizing estate and generation-skipping transfer taxes:

Section 2. Testamentary Limited Powers of Appointment

2.1 In addition, except as otherwise provided herein in ARTICLE __ hereof **[SPECIAL PROVISIONS IF RETIRMENT ASSETS ARE PAYABLE TO THE TRUST - TO BE DISCUSSED BELOW]**, if the beneficiary is not survived by a surviving spouse (as that term is defined for purposes of Section 2056 of the Internal Revenue Code, or any successor section thereto, or for purposes of the law of the state or other jurisdiction in which the beneficiary was domiciled at the time of his or her death, if said state or other jurisdiction has an estate or inheritance tax in effect at the time of the beneficiary's death), then to the extent it will not result in (i) the beneficiary's estate being liable for any federal or state estate or inheritance taxes (assuming no alternate valuation date or similar elections, qualified disclaimers, or deductible administration expenses), (ii) the beneficiary's estate being liable to reimburse any government for any assistance or other benefits provided the beneficiary during the beneficiary's lifetime, (iii) the beneficiary's estate or the trust being automatically subject to income tax on any gain attributable to any portion of the remaining trust assets, or (iv) a reduction in the federal income tax basis of any asset over its historical federal income tax basis, the beneficiary shall have the power to appoint those remaining trust assets, if any, beginning with the asset or assets having the greatest amount of built-in appreciation (calculated by subtracting the trust's income tax basis from the fair market value on the date of death of the beneficiary), as a percentage of the fair market value of such asset or assets on the date of death of the beneficiary, to the creditors of the beneficiary's estate (or to or among the beneficiary's estate and any one or more individuals and/or entities, including a trust or trusts, if the power to distribute such assets to the creditors of the beneficiary's estate is not sufficient to cause a federal income tax basis adjustment under IRC Section 1014, or any successor section thereto, at the beneficiary's death), utilizing the same appointment procedure described in subsection __, above; PROVIDED, HOWEVER, that if this trust has been or will be divided into two separate trusts for federal generation-skipping transfer tax purposes, the beneficiary's foregoing additional power of appointment shall apply (i) first to the trust having an inclusion ratio, as defined in Section 2642(a) of the Internal Revenue Code, or any successor section thereto, of other than zero, but only to the extent such trust is not otherwise already includible in the beneficiary's estate for federal estate tax purposes, pursuant to the other provisions of this trust instrument, and (ii) next to the trust having an inclusion ratio, as defined in Section 2642(a) of the Internal Revenue Code, or any successor section thereto, of zero; PROVIDED FURTHER, HOWEVER, that if the beneficiary is the beneficiary of more than one trust which includes a provision similar to this sentence, under no circumstance shall the beneficiary's estate be liable for any federal or state estate or inheritance tax as a consequence of the beneficiary's foregoing additional power of appointment, and if necessary to carry out this intent, the extent of the beneficiary's foregoing additional power of appointment shall be reduced in proportion to the value of all other trust assets subject to a similar additional power of appointment, or by a greater amount, if further necessary.

2.2 If the beneficiary is survived by a surviving spouse (as that term is defined for purposes of Section 2056 of the Internal Revenue Code, or any successor section thereto, or for purposes of the law of the state or other jurisdiction in which the beneficiary was domiciled at the time of his or her death, if said state or other jurisdiction has an estate or inheritance tax in effect at the time of the beneficiary's death), the beneficiary shall only possess the beneficiary's foregoing additional power of appointment to the same or lesser extent that the trustee (other than the beneficiary and other than a trustee who is "related or subordinate" to the beneficiary within the meaning of current Section 672(c) of the Internal Revenue Code (substituting "the beneficiary" for "the grantor" in said Section)) shall direct by instrument in writing filed with the trust during the beneficiary's lifetime and not revoked by said trustee prior to the beneficiary's death; PROVIDED, HOWEVER, that the trustee shall not possess the foregoing power to direct if the beneficiary appointed the trustee who or which possesses the foregoing power to direct, and if as a consequence the beneficiary is deemed to possess the foregoing power to direct for federal or state estate tax or inheritance tax purposes. In exercising said trustee's broad discretionary power in determining whether and to what extent the beneficiary shall possess the beneficiary's foregoing power of appointment if the beneficiary is survived by a surviving spouse, said trustee shall be primarily concerned with minimizing overall income and transfer taxes to the beneficiary's estate, to the beneficiary's surviving spouse's estate, and to recipients of the trust assets after the beneficiary's death, and with minimizing the liability of the beneficiary's estate to reimburse any government for any assistance or other benefits provided the beneficiary during the beneficiary's lifetime. The trustee shall be entitled to rely on the advice of legal counsel with respect to any matter under this subsection 2.2; PROVIDED, HOWEVER, that if said legal counsel's opinion is subsequently determined to be invalid as applied to this subsection, either as a result of a subsequently passed federal or state law, or a subsequently promulgated regulation or published ruling, or as a result of judicial decision, the matter shall be determined based on such subsequent development and not in accordance with said legal counsel's opinion.

Part 2: Impact of the 2019 Year-End Tax Changes

Commentators appear to be almost uniform in proclaiming the demise of so-called stretch IRA and other defined contributions plan benefits (including 401ks) after the Further Consolidated Appropriations Act, 2020 ("FCAA"). Whereas prior to 2020 designated beneficiaries could defer receipt of IRA and other defined contribution plan benefits over their lifetimes, the new rules generally place a ceiling of 10 years on this deferral. Thus, for example, with certain exceptions including a surviving spouse, a designated beneficiary having a 30-year life expectancy, who previously could have deferred receipt of the IRA or plan benefits over 30 years, must now fully withdraw the benefits within 10 years of the plan participant's or IRA owner's death. Note that under the new law there is no requirement that the IRA, etc., funds be withdrawn under any set schedule during the 10 years, as long as they are all withdrawn within 10 years. [*See* new IRC Section 401(a)(9)(H)(i)].

It is important to point out initially that, although at the outset of new subparagraph (H) the new rules are said to apply only "in the case of a defined contribution plan," at the conclusion of new subparagraph (H) is a provision which deems "all eligible retirement plans (as defined in section 402(c)(8)(B)," other than defined benefit plans, to be defined contribution plans for purposes of applying the provisions of subparagraph (H). This includes IRAs and 401k plans, among all other eligible retirement plans other than pension plans. *See* IRC Section 401(a)(9)(H)(vi).

Nature of the Problem

The two-fold concern created by the new tax law is that not only must all of the tax on the IRA, etc., be paid much earlier than in the past, but the tax rate on the receipts will likely be much higher than in the past, due to the bunching of income during a period when the recipients are likely to be in their peak earning years, e.g., ages 55 through 65.

Take, for example, this typical fact pattern involving the new tax law versus the old:

Assume a $1,000,000 IRA at the time of the account owner's death.

Assume a 5% growth/income rate.

Assume a 60-year-old designated beneficiary, who lives the expected 25 more years.

Assume a 40% combined federal and state income tax rate on a lump sum IRA distribution in year 10 after the owner's death, under new law.

Assume a 35% combined income tax rate if the designated beneficiary elects to take equal IRAs distributions over years 1 through 10 after the account owner's death.

Assume a 30% combined income tax rate on annual IRA distributions under the old law, i.e., because the designated beneficiary will typically not always be in his or her peak earning years, and because the benefits are paid over 25 years.

Assume a 20% combined income tax rate on the income generated by withdrawn funds invested outside of the IRA.

Income tax results to the designated beneficiary under the new law:

Assuming the designated beneficiary elects to take equal payments over 10 years:

If the designated beneficiary takes equal payments over 10 years, the payments would be $82,731 (based on a standard amortization table, at 5%). After 25 years, these payments would grow to $1,854,391, after-tax.

Assuming the designated beneficiary waits until the end of year 10 to take the entire IRA balance:

If the designated beneficiary instead waits until the end of year 10 after the IRA owner's death to take the entirety of the IRA balance, the after-tax amount after 25 years will be $1,760,242, or approximately 5% less than the strategy of spreading the IRA distributions equally over 10 years. Although it appears that in most situations it will be better to take the IRA balance equally over 10 years, such may not be the case if, for example, the beneficiary is five years from retirement at the time of the account owner's death. In the latter case it may be better to take the IRA balance equally over years 6 through 10 after the account owner's death.

Income tax results to the designated beneficiary under the old law:

Under the old law, if the designated beneficiary took only the required minimum distributions over his or her 25-year life expectancy under the IRS tables, the after-tax value of the IRA distributions at the designated beneficiary's age 85 would be $2,204,122. This is about 19% more than the best scenario under the new law, spreading out payments even further at an even lower income tax rate obviously being the difference.

Drafting and Other Solutions

There are a number of alternatives the client can consider in order to mitigate the adverse effects of the new tax law. One strategy which can produce significant long-term benefits for both the client and the client's family is to withdraw greater amounts from the defined contribution plan or IRA than are required, once the client is retired and therefore in a lower tax bracket. Under the IRS tables, required minimum distributions become substantially larger as the account owner approaches life expectancy, and beyond. Thus, only taking the required minimum distributions up until this time will force either the client (if he or she is then living) or the client's family (after the client's death) to likely pay income taxes on the balance of the account at a significantly higher income tax rate than would otherwise be imposed.

Any amount withdrawn early which exceeds the required minimum distribution for the year can be rolled into a Roth IRA, if desired. Blanket large Roth conversions at high income tax rates need to be carefully analyzed however, before moving forward. Does it make income tax sense, for example, to do a large Roth conversion, or even a so-called "laddered Roth conversion," while the owner is still employed, and therefore already in a significant income tax bracket?

A similar "number crunching analysis" needs to take place before opting for a charitable remainder trust, whether of the annuity or unitrust variety, as a solution to the income tax acceleration problem. Often the result of this approach will be a reduction of income taxes, but not necessarily an increase in the after-tax amount passing to the owner's family. Except in the case where the owner is already charitably inclined, rather than improve the situation the family may actually be worse off with this type of planning, because the principal of a charitable remainder trust may not be accessed by the family.

If the estate planning attorney is faced with a second marriage estate planning situation, especially one where each spouse has a child or children from a previous marriage, oftentimes the couple may choose to leave a portion of their separate estates to the new spouse, if he or she survives, and the balance to his or her own child or children. In this frequently-experienced situation, which is the most "tax-wise" asset to leave to the surviving spouse and which is the most tax-wise asset to leave to the children? Given the fact that the post-death deferral rules have not changed for IRA and 401k proceeds left to a surviving spouse, but like amounts left to children (other than children who have not attained the age of majority) must now be distributed within 10 years after the owner's death, the previous advantage of leaving the IRA or 401K to the children, so that they may defer receipt of the same over a much longer period than the surviving spouse, may no longer be the case. It may actually make more sense today to use a portion of the IRA or 401k to fund the surviving spouse's share, in order to avoid the new requirement that accelerates the distribution of the IRA or 401k in the case of distributions to a child or children.

A separate planning idea which directly involves the estate planning attorney is for the client to consider paying all or part of the IRA or defined contribution plan portion of the owner's estate to lower income tax bracket beneficiaries, where possible. The theory here is that, if we have to live with the new tax law, at least minimize its effects by planning our estates in a tax-wise manner.

Assume, for example, that an account owner has four children, two in high income tax brackets and two not. Why not consider leaving the IRA portion of the account owner's estate to the children in lower income tax brackets, with the basis stepped-up assets to the others? Of course, a drafting adjustment should be made for the fact that the lower tax bracket children will be receiving taxable income, whereas the others will not be. The amount of these compensating adjustments may need to be change over time, depending on all relevant factors, including the children's anticipated future income tax situations.

This plan can be taken a step further if the account owner is interested in leaving a portion of his or her estate to grandchildren and/or great grandchildren, who may be in even lower income tax brackets than the lower tax bracket children (subject, of course, to the Kiddie tax). Just because an existing plan to defer income tax on IRA assets over the lifetime of grandchildren and/or great grandchildren will no longer be possible, does not mean distributions to grandchildren and/or great grandchildren in lower tax brackets (and who are usually also more in number than children, thus spreading the IRA, etc. income over more taxpayers) is not still a beneficial income tax planning strategy, due to the lower overall income taxes which often may result.

Here is a sample form to illustrate one type of "tax adjustment" clause which can be used as part of this option:

> Special Adjustment Where Retirement Assets Not Distributed Consistently
>
> If, upon the death of the grantor, via beneficiary designation, the grantor's retirement assets (as defined in ARTICLE __, below) are not distributed to or in trust for the benefit of the grantor's descendants on a per stirpes basis (the term "per stirpes" being defined in ARTICLE __, below), then, notwithstanding any other provision of this instrument to the contrary, in distributing the shares of the trust estate passing pursuant to the provisions of ARTICLE __ hereof, the value, as of the date of the grantor's death, of all retirement assets which are distributed to any individual or trust via beneficiary designation (valued as of the date of the grantor's death) shall be added to the value of all of the assets passing under ARTICLE __ hereof for the purposes of determining the shares under said ARTICLE, and the share or shares of the individuals or trusts under said ARTICLE shall then be reduced (but not below zero) by the amount (as so valued) of retirement assets passing to the individual or trust via beneficiary designation.

Assume, for example, that a client has two children, A (in a 20% combined federal and state income tax bracket) and B (in a 40% combined federal and state income tax bracket), and an estate consisting of a $1 million IRA and $1.5 million in cash, investments and real estate outside of the IRA. If instead of leaving the IRA equally to A and B, with your guidance the client decides to leave the $1 million IRA all to child A, with the cash, investments and real estate held outside of the IRA split equally under the client's trust instrument between the two children, but subject to the above form language.

Assume also that, again with your guidance, the client elects to make a specific cash gift to A of $200,000, in order to compensate A for the estimated income taxes A will need to pay on the $1 million IRA. [Note that in estimating this income tax amount, the client needs to "gross up" the child's anticipated annual income by 10% of the IRA proceeds.] Based on the aforesaid assumptions, the above form language would result in the client's $2,500,000 total assets being distributed as follows:

> a. Child A would receive: (1) the $1 million IRA passing outside of the trust instrument; (2) the $200,000 cash gift the client elected to leave A to compensate for the income taxes A will pay on the IRA distributions; and (3) $150,000 cash, investments and real estate, or $1,350,000 total; and

b. Child B would receive $1,150,000 cash, investments and real estate, with no benefits under the IRA, and no compensating adjustment since B will not be paying taxes on IRA distributions.

On an after-tax basis, A receives 800K worth of IRA plus 350K [i.e., 200K + 150K] worth of cash, investments and real estate, or $1,150,000, total, net of taxes. Had there been no tax planning, A would have received $1,150,000, net of taxes, so A's situation remains the same.

B, on the other hand, now receives $1,150,000, income tax free, or $100,000 more than B would have received, net of taxes, had there been no tax planning [i.e., $750,000 cash, investments and real estate, plus $300,000 after-tax value of one-half interest in IRA].

Each child receives an identical amount, net of taxes, and the family as a whole comes out $100,000 ahead. These tax advantages could obviously be even greater if the IRA were left to grandchildren or great grandchildren in lower tax brackets, subject, of course, to the potential application of the Kiddie Tax rules.

The above-outlined plan has the additional benefit of essentially treating the new tax law as an estate tax on the client's estate. Most clients wish for their assets to pass equally to their children at their deaths, after all taxes. The above tax-wise IRA beneficiary plan helps carry out this intent, saving the family significant tax dollars, in the process.

Additional Drafting Considerations for Payments of IRAs, etc. to Trusts

Does paying IRA, etc., funds to trusts after the death of the account owner, to protect the funds for the beneficiary, including protection against lawsuits, divorce, and estate taxes, still make sense under the new law? Many will argue it does not, because of the high income tax rates on trusts which will now apply, in full force, when IRA, etc., proceeds are paid to a trust over a maximum of 10 years.

Recall the above discussion, however, to the effect that the high income tax rates on trusts can be addressed through the judicious use of Section 678 of the Internal Revenue Code in the drafting of the trust, which causes the income of the trust to be taxed at the beneficiary's income tax rates, and not the trust's rates. Lapsing these withdrawal rights only to the extent of 5% of the trust annually will not only eliminate any potential adverse estate or gift tax consequences, but in most jurisdictions will also eliminate any potential asset protection issues on the annual lapsed withdrawal rights.

Thus far we have been discussing tax saving strategies applicable to so-called "accumulation trusts." These same strategies will not work in the case of so-called "conduit trusts," because conduit trusts mandate that all IRA and plan distributions paid to the trust in turn be paid out to the designated beneficiary of the trust, upon receipt. Conduit trusts obviously solve the high trust tax rate issues associated with the compressed 10-year deferral period, but at the expense of obviating the reasons estate planning attorneys use trusts in the first place, e.g., asset protection, estate tax protection and divorce protection, along with general protection for young and/or spendthrift children.

Despite their advantages over conduit trusts in most instances under the new tax law [see the discussion on "eligible designated beneficiaries," below, for situations where conduit trusts may be preferable], existing accumulation trusts may still need to be modified in order to ensure the 10-year deferral period for payments to a "designated beneficiary" is achieved over the 50%

shorter 5-year default period. If the shorter 5-year default period is imposed, it will be almost impossible to navigate the high income tax rates on trusts, even utilizing the combination of the IRC Section 678 and other tax savings strategies discussed above. This is because the IRA, etc., payments will be 20% or more per year, under the 5-year default rule. It is thus incumbent on the drafting attorney to ensure that the trust qualifies under the 10-year alternate period in the case of payments to a "designated beneficiary" as defined in new IRC Section 401(a)(9)(E)(i). *See* IRC Section 401(a)(9)(H)(i).

Even though life expectancy is irrelevant to the new 10-year rule, there remains a concern that provisions like this one found in current Section 1.401(a)(9)-4, A-1 of the Regulations, may nevertheless still apply:

> A designated beneficiary need not be specified by name in the plan or by the employee to the plan in order to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan. *The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it possible to identify the class member with the shortest life expectancy*.

Unless and until these regulations are revised, if the trust includes a testamentary limited power of appointment to the surviving spouse of the beneficiary, or automatically continues the trust for the surviving spouse after the death of the beneficiary, with no age limit being placed on the surviving spouse, the trust may not qualify for 10-year deferral because it is impossible to identify the class member with the shortest life expectancy. If the goal is to achieve a 10-year deferral rather than the default 5-year, there should therefore be some age limit imposed on the potential surviving spouse, e.g., no more than 100 years older than the grantor of the trust.

Similarly, the trust document should be prepared to ensure that any contingent gift cannot pass to an individual more than 100 years older than the grantor of the trust and, of course, that adopted descendants of the grantor can only consist of individuals younger than the descendant doing the adopting. Finally, charities and other non-individual beneficiaries and appointees, including the beneficiary's estate or the creditors of the beneficiary's estate, will not qualify as designated beneficiaries, because they are not individuals. IRC Section 401(a)(9)(E)(i).

Compare the situation which existed prior to 2020, where not only was it necessary to determine the class member with the shortest life expectancy, but the life expectancy of this person was the determining factor in discerning the maximum IRA, etc., payout period. To qualify for the new 10-year deferral period, it is only necessary to place some limit on the age of the class members.

If a charity (i.e., with no life expectancy) is a potential remainderman under a trust, or if, for the purpose of obtaining income tax basis step-up at the death of the beneficiary, the beneficiary is given a testamentary general power of appointment to the beneficiary's estate or to the creditors of the beneficiary's estate (each of which also has no life expectancy), the attorney drafter will need to divide the trust for the beneficiary into two shares, and ensure that in the "IRA share" it is possible to identify the individual class member with the shortest life expectancy, and that it is impossible for a non-individual to take.

Here is some sample language which can be employed to accomplish the above objectives, while still ensuring that estate and generation-skipping transfer taxes are minimized at the beneficiary's death:

Separate Accounting for Retirement Assets

If (A) one or more charitable organizations is a potential beneficiary under ARTICLE __ hereof and/or if one or more charitable organizations, the primary current beneficiary of the trust (as defined in ARTICLE __ hereof, and hereinafter referred to as "the beneficiary"), the beneficiary's estate, the beneficiary's creditors and/or the creditors of the beneficiary's estate is or are a potential appointee or appointees of the remaining trust assets at the beneficiary's death, and (B) (i) any retirement assets (as defined in paragraph 5, below) shall become payable to any trust hereunder as a result of the grantor's death, whether immediately or over time, and (ii) assuming the below described Share A/B arrangement is established, the aggregate present fair market value (as of the date of the grantor's death, and as determined for federal estate tax purposes, if the federal estate tax is in existence at the time of the grantor's death, otherwise as determined by the trustee, in the trustee's sole discretion) of all of said retirement assets (as so defined) payable to all trusts hereunder which are to be established as a result of the grantor's death, divided by the total number of said trusts, shall exceed $____________, then (C) the trustee shall set aside and maintain as a separate share (hereinafter referred to as "Share A") from the remainder of the assets of each trust established hereunder (hereinafter referred to as "Share B"), said trust's right to receive all retirement assets (as so defined), together with the proceeds from the same, and with respect to any such separate shares created hereunder, the following rules shall apply notwithstanding any other provision of this instrument to the contrary:

1. No testamentary power of appointment in Share A may be exercised in favor of any charitable organization or in favor of the beneficiary, the beneficiary's estate, the beneficiary's creditors or the creditors of the beneficiary's estate.

2. For purposes of construing the provisions of the "CONTINGENT REMAINDER INTERESTS" under ARTICLE __ hereof which will potentially apply at the termination of Share A, all charitable organization takers shall be deemed to be not then in existence.

3. If the trust has an inclusion ratio, as defined in Section 2642(a) of the Internal Revenue Code or in any successor section thereto, of other than zero, and if, assuming the primary current beneficiary of the trust died immediately, a "taxable termination" as defined in Section 2612(a) of the Internal Revenue Code or in any successor section thereto, would occur, then the primary current beneficiary of the trust shall have the power to withdraw all of the income and principal of Share A of the trust, but only with the consent of the then acting trustee or co-trustees of the trust (other than the primary current beneficiary of the trust or any institution in which the primary current beneficiary of the trust owns any interest) who and/or which is/are not adverse to the exercise by the primary current beneficiary of the trust of the aforesaid power of withdrawal (within the meaning of Internal Revenue Code Section 2041(b)(1)(C)(ii), or any successor section thereto, and Section 20.2041-3(c)(2) of the Treasury Regulations, or any successor section(s) thereto), or if all of the then acting trustees (other than the primary current beneficiary of the trust or any institution in which the primary current beneficiary of the trust owns any interest) are adverse to said exercise, then only

with the consent of a nonadverse individual or institution (other than the primary current beneficiary of the trust or any institution in which the primary current beneficiary of the trust owns any interest) designated by the then acting trustee or co-trustees of the trust (other than the primary current beneficiary of the trust or any institution in which the primary current beneficiary of the trust owns any interest), or, if no such nonadverse individual or institution has been designated, only with the consent of the institution (or its successor) designated herein as the sole ultimate successor institutional trustee of the trust. (The previous provisions of this paragraph 3 shall not be construed as a limitation on any trust beneficiary who is already entitled to receive all of the income of the trust currently, pursuant to the terms of the trust, or who already possesses a current right to withdraw all or any portion of the trust income or principal, pursuant to the terms of the trust.)

4. If the foregoing provisions of this Section apply to the trust, said provisions shall continue to apply to any other trust which is subsequently funded utilizing assets of the original trust, in whole or in part.

5. The term "retirement assets" shall mean any asset classified as part of a qualified plan pursuant to Section 401 of the Internal Revenue Code, or any successor section thereto, as part of an annuity payable under Section 403(a) or 403(b) of the Internal Revenue Code, or any successor sections thereto, as part of an individual retirement account (including a simplified employee pension) pursuant to Section 408 of the Internal Revenue Code, or any successor section thereto, as part of a ROTH IRA pursuant to Section 408A of the Internal Revenue Code, or any successor section thereto, as part of an inherited IRA established by the trustee pursuant to Section 402(c)(11) of the Internal Revenue Code, or any successor section thereto, as part of a retirement plan pursuant to Section 457 of the Internal Revenue Code, or any successor section thereto, or as part of any similar qualified retirement arrangement under the Internal Revenue Code.

The “Current Income Taxation” vs. “Income Tax Basis Step-Up" Tradeoff

As alluded to above, it is now possible to design a “two-share” trust which will minimize current income taxes and achieve income tax basis step-up at the death of the income beneficiary. The income tax basis step-up will not be available for the “IRA portion” of the trust, however, because the power to appoint to the beneficiary’s estate or to the creditors of the beneficiary’s estate creates an impermissible non-individual beneficiary, thus eliminating the chance to achieve 10-year deferral on the “IRA portion” of the trust. Unfortunately, therefore, in our effort to achieve 10-year versus the default 5-year deferral for the “IRA portion” of the trust, we may have necessarily cost the next generation significant capital gain tax dollars.

What if we are faced with a high net worth situation where the possibility of a significant loss of income tax basis step-up on the “IRA portion” of the trust at the current beneficiary’s death (of course without causing increased estate taxes) is very real? Are there situations out there where the family might be better off foregoing the five extra years of current income tax deferral on the “IRA portion” of the trust, in an effort to potentially achieve significant income tax basis step-up on the entire trust for the next generation, when the current beneficiary passes?

Although these situations would not have been likely under the old lifetime deferral rules, these situations no doubt will exist today, and, when they do arise in our practices, the client may decide to employ a one-share trust approach which includes a testamentary conditional (i.e., to the extent it will not cause federal or state estate or inheritances taxes at the current beneficiary's death) general power of appointment over the entire trust. This approach will obviously cause significant income taxes to be payable on the IRA, etc., receipts during the 5-year payout period (whether to the trust or to the current beneficiaries), so this approach should therefore only be utilized when the lifetime beneficiaries would be in high income tax brackets regardless, i.e., in the event the IRA, etc., proceeds were spread over the alternative 10-year period.

Unscrambling the New "Eligible Designated Beneficiary" Rules

The new "eligible designated beneficiary" provisions of the Internal Revenue Code are unnecessarily complex, with their multiple cross-references to various sections of the Internal Revenue Code, run-on sentences, confusing (if not misleading) terminology, etc. The goal of this penultimate section (yes, we're almost done!) of this article is to unscramble these provisions in order to make them as comprehensible as possible for the reader.

Under new IRC Section 401(a)(9)(E)(ii), the term "eligible designated beneficiary" includes any designated beneficiary who is (I) the surviving spouse of the employee, (II) a child of the employee who has not reached "majority" (a seemingly simple word which, as defined in the regulations under IRC Section 401(a)(9)(F), specifically Section 1.401(a)(9)-6, A-15, can include a child of up to 25 years of age in certain defined situations - but who for purposes of this article will be referred to simply as: "a minor child of the employee"), (III) a disabled individual, (IV) certain chronically ill individuals, and (V) anyone else who is not more than 10 years younger than the employee. The term "eligible designated beneficiary" is relevant because new IRC Section 401(a)(9)(H)(ii) provides that IRC Section 401(a)(9)(B)(iii), which creates an exception to the now 5-year and 10-year rule limitations "if any portion of the employee's interest is payable to (or for the benefit of) a designated beneficiary," must now be read to "apply only in the case of an eligible designated beneficiary."

The other requirements of IRC Section 401(A)(9)(B)(iii) have not been changed. Thus, (A) the portion of the employee's interest must also "be distributed (in accordance with regulations) over the life of such [eligible] designated beneficiary (or over a period not extending beyond the life expectancy of such [eligible designated] beneficiary)," and (B) such distributions must "begin not later than 1 year after the date of the employee's death or such later date as the Secretary may by regulations prescribe." If (A) and (B) are met, the qualified plan or IRA will be treated as a "qualified trust" under IRC Section 401(a)(9).

Let's unpack these new rules further. It will be virtually impossible to create a trust which exclusively benefits an "eligible designated beneficiary," because the trust will have remaindermen. Does this mean that only an outright distribution to the "eligible designated beneficiary" will qualify for lifetime deferral under the new law? The answer should be No.

Under new IRC Section 401(a)(9)(H)(iii), what happens is that if "an eligible designated beneficiary dies before the portion of the employee's interest . . . is entirely distributed, . . . the remainder of such portion shall be distributed within 10 years after the death of such eligible designated beneficiary." In the case of an individual who is an "eligible designated beneficiary" by reason of being a minor child of the employee, the 10-year payout rule begins on the earlier of the death of the child or the date the child reaches majority. IRC Sections 401(a)(9)(E)(iii), 401(a)(9)(H)(iii).

So now we have it! Trusts for "eligible designated beneficiaries" do qualify for lifetime deferral. It is just that, under the new law, other lifetime and remainder beneficiaries of the "IRA portion" of trust are irrelevant because (i) presumably other lifetime beneficiaries who are not "eligible designated beneficiaries" are not permitted if lifetime deferral is desired, and (ii) remainder beneficiaries do not matter because the trust *must* effectively function as a conduit trust, turning over all IRA, etc., distributions to the beneficiary upon receipt.

Because most trusts will have remaindermen who are not "eligible designated beneficiaries," it is impossible to utilize an accumulation trust [at least for the "IRA portion" of the trust] if lifetime deferral is the goal. To be clear, the trust can have lifetime or remainder beneficiaries who are not "eligible designated beneficiaries," as long as these "non-eligible" beneficiaries cannot share in the IRA, etc., proceeds during the lifetime or minority of the eligible designated beneficiary. Upon the death of the eligible designated beneficiary, or when an eligible designated beneficiary who is a minor attains the age of majority, the balance of the IRA, etc., account must be paid out, to anyone, including to the trust, and apparently even including to a beneficiary which does not qualify as a "designated beneficiary" (e.g., charity), within 10 years. IRC Sections 401(a)(9)(H)(iii), 401(a)(9)(E)(iii).

One thought to ponder is whether we will want to utilize this "new" conduit trust approach in the case of a minor child. Does it make tax sense to "transfer" the bulk of the IRA, etc., income to the 10 of the child's working (i.e., income-producing) years, when it could have been withdrawn by the trustee over 10 of the child's non-working years, i.e., his or her years as an unemployed minor, especially considering the obvious negatives associated with distributing IRA, etc., proceeds to a minor, or even to a conservatorship or custodianship for a minor, which the minor can freely access upon attaining the applicable age of majority.

Before turning to the special rules applicable to disabled and chronically ill individuals, there is one other category of "eligible designated beneficiaries" which needs to be studied. This category applies to any other individual "who is not more than 10 years younger than the employee." IRC Section 401(a)(9)(E)(ii)(V). This individual would normally be a close friend or relative, but of course it could be anyone who fits into the category. The important point to note is that the same analysis discussed above applicable to surviving spouse eligible designated beneficiaries, should apply here. Thus, payments to a trust for the beneficiary must be in the form of a conduit trust, at least as to the "IRA portion" of the trust, and when the beneficiary passes the remaining balance of the IRA, etc., must be paid out within 10 years, to anyone, including to the trust, and apparently including to a beneficiary which does not qualify as a designated beneficiary (e.g., charity).

<u>Unscrambling the New "Applicable Multi-Beneficiary Trust" Rules</u>

The new "applicable multi-beneficiary trust" provisions of the Internal Revenue Code may be even more difficult to follow than the new "eligible designated beneficiary" rules - if that is possible. We will study these rules in the same manner we studied the "eligible designated beneficiary" rules, i.e., by first attempting to understand the meaning of the term "applicable multi-beneficiary trust," and then by attempting to understand the relevance of the term.

According to new IRC Section 401(a)(9)(H)(v), an "applicable multi-beneficiary trust" means a trust:

> "(I) which has more than one beneficiary,
>
> (II) all of the beneficiaries of which are treated as designated beneficiaries for purposes of determining the distribution period pursuant to this paragraph, and
>
> (III) at least one of the beneficiaries of which is an eligible designated beneficiary described in subclause (III) or (IV) of subparagraph (E)(ii)."

The eligible designated beneficiaries described in subclause (III) and (IV) of paragraph (E)(ii) are disabled and chronically ill individuals.

The first question which naturally arises is whether a typical special needs trust, which normally only benefits one individual during the lifetime of that individual, qualifies as an "applicable multi-beneficiary trust." Because remainder beneficiaries of a trust are still beneficiaries of the trust, and the "applicable multi-beneficiary trust" definition does not limit the phrase "has more than one beneficiary" to lifetime beneficiaries, it would appear that the standard special needs trust meets requirement (I) of the definition. Furthermore, because most special needs trusts are drafted with the disabled individual as the only lifetime beneficiary, any other reading of this Code language would render the section practically moot.

Requirement (II) of the "applicable multi-beneficiary trust" definition is that all of the beneficiaries of the trust must be "treated as designated beneficiaries for purposes of determining the distribution period pursuant to this paragraph." This is not actually a trust drafting requirement, but rather a requirement for computing the applicable distribution period for the IRA, etc., payments. What is significant here is that all of the beneficiaries "of the trust," regardless of whether they have any ability to share in the IRA, etc., proceeds which are distributed to the trust, apparently must be included in figuring out the designated beneficiary with the shortest life expectancy. This is a departure from the previous rules relative to accumulation trusts. Caution should therefore be the rule, as this may require the establishment of two separate trusts (i.e., not just two separate shares of one trust) when a special needs beneficiary is involved, one where older individual beneficiaries and/or non-individual beneficiaries (e.g., charity) can benefit, and one (i.e., the "IRA share") where they cannot.

Thus, and because "by definition" requirement (III) of the definition would have been met, the typical special needs trust which we all prepare qualifies as an "applicable multi-beneficiary trust." The next question is: How is this new term relevant in new subparagraph (H) and revised subparagraph (E)?

New IRC Section 401(a)(9)(H)(iv) provides that, in the case of an "applicable multi-beneficiary trust" (which, again, is basically a trust which has at least two beneficiaries, including remaindermen, at least one of whom must be disabled or chronically ill), two different scenarios may arise. Under the first scenario ("Scenario I"), if, under the terms of the trust, the trust is to be divided upon the death of the employee into separate trusts for each beneficiary, the lifetime payout exception under IRC Section 401(a)(9)(B)(iii) for eligible designated beneficiaries is to be applied separately with respect to the portion of the employee's interest in the IRA, etc., account that is payable to any disabled or chronically ill eligible designated beneficiary.

The language "that is payable to" any disabled or chronically ill eligible designated beneficiary does not make sense when applied in the context of Scenario I. As just described, in order for Scenario I to exist, the establishment of separate trusts for each beneficiary is required. Thus, there is no "amount payable to" any disabled or chronically ill eligible designated beneficiary, under Scenario I.

One can only surmise that perhaps what Congress intended here was to write "amount payable to any trust for the benefit of" any disabled or chronically ill eligible designated beneficiary. If this is the case (and it is impossible to tell, for sure), the intent may merely mean that such a trust will qualify for the lifetime payout exception if it structured in the same "conduit trust" fashion described in the case of a trust for a surviving spouse "eligible designated beneficiary." Once the disabled or chronically ill beneficiary dies, the balance of the IRA, etc., must then be paid out within 10 years, again presumably to any beneficiary, including the trust or a non-individual beneficiary (e.g., charity). Distributing the balance of the IRA, etc., to beneficiaries who are not individuals should not be problematic under the above-discussed rule that "all of the beneficiaries" of an "applicable multi-beneficiary trust" must be "treated as designated beneficiaries for purposes of determining the distribution period pursuant to this paragraph," because in the case of a conduit trust (i.e., the Scenario I trust) remaindermen of the trust are irrelevant.

Of course, most attorneys are unwilling to draft a trust for a disabled or chronically ill beneficiary in a fashion which may disqualify the beneficiary for government aid, assuming such aid is available. This is no doubt the reason why Congress chose to add a second scenario ("Scenario II") applicable in the case of disabled or chronically ill beneficiaries, which scenario not only solves the government aid qualification issue, but also allows other beneficiaries to benefit from the trust during the disabled or chronically ill beneficiary's lifetime, as long as these other beneficiaries cannot benefit from the IRA, etc., proceeds during the disabled or chronically ill beneficiary's lifetime.

Scenario II applies if, under the terms of the trust, no individual (other than a disabled or chronically ill beneficiary) has any right to the employee's interest in the plan until the death of all disabled or chronically ill beneficiaries of the trust. If Scenario II applies, the lifetime payout exception under IRC Section 401(a)(9)(B)(iii) applies "to the distribution of the employee's interest and any beneficiary who is not such an eligible designated beneficiary shall be treated as a beneficiary of the eligible designated beneficiary upon the death of such eligible designated beneficiary." Although there can be other beneficiaries of a Scenario II trust, even if the trust is carefully drafted so that these beneficiaries have no interest in the IRA, etc., or its proceeds, at any time, the beneficiaries will apparently still count for purposes of determining the designated beneficiary with the shortest life expectancy, and therefore the distribution period applicable to the IRAs, etc.

Note that, unlike a Scenario I special needs trust, where the remaining IRA, etc., benefits must be paid out within 10 years of the disabled or chronically ill individual's death, in the Scenario II situation Congress' apparent intent is that the pre-2020 "lifetime payout" rules apply. In other words, in determining whether the lifetime payout exception under IRC Section 401(a)(9)(B)(iii) of the Code applies, as well as the designated beneficiary with the shortest life expectancy (including, potentially, the disabled or chronically ill beneficiary) for purposes of determining the payout period, we revert to this language from Section 1.401(a)(9)-4, A-1 of the Regulations which was cited at the outset of this second part of this article:

> The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it possible to identify the class member with the shortest life expectancy.

This reading draws support from the fact that the Code provides that an "applicable multi-beneficiary trust" means a trust "all of the beneficiaries of which are treated as designated beneficiaries for purposes of determining the distribution period pursuant to this paragraph." The Code creates a new "class of beneficiaries" in the case of the Scenario II "special needs" trust, which includes all beneficiaries (individual and non-individual) of the special needs trust, regardless of whether any of these beneficiaries has a interest in the IRA, etc., or its proceeds. If a non-individual beneficiary of the trust exists, including as a remainderman, it is impossible to identify the class member with the shortest life expectancy (e.g., because a charity has no life expectancy), and therefore the special needs trust will be subject to the 5-year payout period.

Under this reading of the new Code provisions applicable to traditional special needs trusts, the age of all individual designated beneficiaries of the trust, including remaindermen, becomes relevant, just as it did for all accumulation trusts prior to the year 2020. The reason these pre-2020 rules are relevant in the case of a special needs trust, but not in the case of trusts for the benefit of "eligible designated beneficiaries" generally (including non-special needs trusts for a surviving spouse of the employee, a minor child of the employee, a disabled or chronically ill individual, or any other individual who is not more than 10 years younger than the employee), is that these latter types of trusts must be drafted in a "conduit" fashion in order for the trusts to qualify as eligible designated beneficiaries, and therefore effectively there are no other beneficiaries having any interest in the IRA, etc., proceeds.

<u>Further Steps</u>

The 2017 and 2019 year-end tax law changes have significantly altered the income tax consequences of utilizing trusts in estate planning. It is therefore essential that estate planning attorneys study and have a strong grasp on the-above described new as well as existing tax laws, in order to be able to properly draft trust documents that meet the clients' non-tax expectations while also providing the best tax results for their heirs.

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Mr. Blase is the principal of the law firm Blase & Associates, LLC, in St. Louis, Missouri. He is also an adjunct professor at the St. Louis University School of Law, where he currently teaches a course in wills, trusts and estates, and an adjunct professor at the Villanova University Charles Widger School of Law, where he currently teaches a graduate course in income taxation of trusts and estates. Mr. Blase has published over 50 articles on estate and tax planning with various peer review journals, and is the author of the book *Optimum Estate Planning.*

Mr. Polley is an attorney who has been working with Mr. Blase at Blase & Associates, LLC, since 2008. He contributed greatly to the preparation of this article.