By James G. Blase & Mimi G. Sharamitaro

Consider the MAT

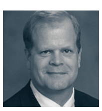
The modified accumulation trust offers the advantages of conduit and accumulation trusts—without their drawbacks

Recent private letter rulings issued by the Internal Revenue Service[1] have created concern among estate-planning attorneys regarding the best way to draft trusts that are intended as potential receptacles of IRA or other qualified plan benefits upon the death of the participant. This concern stems from the fact that, unless the trust is properly drafted, it won't be possible to stretch out the payment of the retirement benefits over the trust beneficiary's lifetime.

One alternative to ensure the maximum possible income tax deferral for the retirement benefits is the so-called "conduit trust" described in the final IRS regulations. The problem is that conduit trusts have numerous problems for most estate-planning clients. Another approach, sometimes referred to as the "accumulation trust" approach, has its own set of potential problems.

I suggest lawyers consider using what I call the "modified accumulation trust" or "MAT." Hopefully this trust alternative will provide clients with maximum deferral of income taxes on qualified retirement plan and IRA benefits after the participant's death—but without creating other significant estate-planning problems.

A similar approach should apply to non-qualified annuities payable to trusts after the holder's death, provided the particular non-qualified annuity contract in question permits payments to a trust after the holder's death over the life expectancy of the trust beneficiary.

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The Playing Field

On April 17, 2002, final regulations relating to the payment of plan benefits to trusts were published in the Federal Register applicable to calendar years beginning after Jan. 1, 2003.[2] These final regs specify that if a beneficiary's entitlement to the participant's benefit is contingent on an event other than the participant's death or the death of another beneficiary, the contingent beneficiary is considered in determining which designated beneficiary has the shortest life expectancy as well as whether any beneficiary is not an individual.[3]

The final regs also provide that a person will not be considered a beneficiary for purposes of determining (1) who is the beneficiary with the shortest life expectancy, or (2) 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 beneficiaries after the beneficiary's death.[4] Instead, if the person 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 beneficiary upon that beneficiary's death," the person will be considered a beneficiary for these purposes.[5]

Retirement expert Natalie B. Choate has an excellent summary of the IRS rules in her handbook, *Life and Death Planning for Retirement Benefits: The Essential Handbook for Estate Planners*.[6] "How does the mere potential successor rule apply to a trust?" she writes. "The IRS recognizes two types of trusts, called in this book 'conduit trusts' and 'accumulation trusts.'

"Under a conduit trust, because the trustee is required to pass all plan distributions out to the individual trust beneficiary, the IRS regards the conduit beneficiary as the sole beneficiary of the trust; all beneficiaries other than the conduit beneficiary are considered mere potential successors and are disregarded.

"Any trust that is not a conduit trust is an accumulation trust, meaning that the trustee has the power to accumulate plan distributions in the trust. Under an accumulation trust . . . some or all of the potential remainder beneficiaries do count (i.e., they are not disregarded) for purposes of the MRD [minimum required distribution] rules."

Problems with Conduit Trusts

The significant drawbacks inherent to the conduit trust approach are self-evident to the attorney practicing in the estate-planning area. Among the potential undesirable results are:

- forcing annual conduit trust payments onto a minor beneficiary;
- forcing annual conduit trust payment onto a younger (even though not a minor) beneficiary;
- forcing annual conduit trust payments onto a beneficiary who is older but a spendthrift;
- forcing annual conduit trust payments onto a special needs child;
- forcing annual payments onto a surviving spouse from a second marriage, when the desire is that the trust corpus pass to the descendants of the first spouse to die at the surviving spouse's death (which would normally be the case when a trust is used);
- subjecting conduit trust payments to potential creditors of the beneficiary;
- subjecting conduit trust payments to the potential rights of a divorced spouse; and
- subjecting conduit trust payments, compounded over the lifetime of the beneficiary, to estate tax at the life beneficiary's death as well as at the subsequent deaths of the beneficiary's descendants.

Practicing estate-planning attorneys, who have for years prided themselves on their ability to provide protection against all of these potential issues, naturally will want something better than a conduit trust approach to qualifying retirement benefits for the maximum potential income tax deferral.

Problems with Accumulation Trusts

Accumulation trusts designed to provide maximum income tax deferral for qualified plan and IRA benefits, while not suffering from any of the problems associated with conduit trusts, have their own set of estate-planning concerns, including:

- Contingent takers under the accumulation trust may not include individuals who are older than the lifetime beneficiary of the trust, because the IRS then might seek to include these older individuals for purposes of determining the shortest life expectancy of the trust.
- Contingent takers under the accumulation trust many not include one or more charities or an undetermined surviving spouse, because the IRS then might argue that the trust has no designated oldest individual beneficiary.
- The accumulation trust may not include a limited testamentary power of appointment in favor of charities, surviving spouses, or older beneficiaries, because the IRS then might argue that there is either no designated oldest individual beneficiary of the trust (that is to say, when a charity or an undetermined surviving spouse is a permissible appointee), or at least that the trust must use the oldest permissible individual appointee as the individual beneficiary with the shortest life expectancy.

A Possible Solution

Through PLRs interpreting the final regulations, the IRS has created a "rule" that Natalie Choate very succinctly and accurately identifies as: "Under the approach exemplified in [PLR 200438044], and in PLRs 200522012 and 200610026 to the same effect, once you find a now-living person who is entitled to outright ownership of the benefits on the death(s) of the prior limited interest beneficiary(ies), all other potential subsequent beneficiaries are disregarded as mere potential successors to the 'outright ownership' remainder beneficiary."[7]

Regardless of whether we agree that the approach the IRS has taken in its recent PLRs is supported by the final regulations themselves, the fact is that these PLRs nevertheless exist, and estate planners therefore need to know how best to deal with them in a manner that does not hamper their clients' other legitimate estate-planning objectives.

Once all conduit and accumulation trusts' potential drawbacks are explained, very few clients who own interests in substantial qualified retirement plan benefits and/or IRAs are enamored by the possibility of establishing them, even to ensure maximum deferral of income taxes on qualified plan and IRA benefits. Yet clients often still want the principal advantage of these trusts—the ability for their beneficiaries to defer income tax on the retirement plan and IRA benefits.

One potential solution is the MAT (See "A MAT Sample Form," p. 44.)

A MAT includes these seven provisions, some of which are mandatory; others are optional:

(1) A MAT must include a Share A and a Share B. Share A is the trust's right to receive the benefits under all qualified retirement plan benefits and IRAs, including Roth IRAs, and including the proceeds and reinvested proceeds therefrom. Share B is all other trust assets.

(2) Permissible testamentary appointees under Share A of the MAT may include only descendants of the primary current beneficiary of the trust's parents in the same or younger generation as the primary current beneficiary of the trust.

(3) If desired, permissible appointees under Share A of the MAT also may include a surviving spouse who is no older than a designated number of years older than the primary current beneficiary of the trust.

(4) In the event of the death of the MAT's primary current beneficiary before the trust terminates, all potential outright remaindermen of Share A (including contingent remaindermen) who are older than the oldest living descendant[8] of the grantor at the time of the grantor's death (assuming all such descendants were alive at the termination of the trust), and all non-individual remaindermen, should be deemed to be deceased or not in existence for purposes of construing the remaindermen provisions (including contingent provisions) that would otherwise apply. To ensure that contingent takers of the client's retirement benefits be as closely related to the grantor as possible, if the application of this rule will result in all otherwise then-living descendants of the grantor's (and, if applicable under the trust document, the grantor's spouse's) parents being deemed to be deceased, then the youngest living remainderman who is a descendant of either the grantor's (or the grantor's spouse's) parents should not be deemed to be deceased under such circumstances.

(5) Outright remaindermen (including contingent remaindermen) who were deemed to be deceased or not in existence for purposes of construing Share A of the MAT will receive a priority distribution of Share B assets until they have received an amount sufficient to "make them whole" with respect to what they would have received from Share A, had they not been deemed to be deceased or not in existence.

(6) To avoid a potential escheat situation, if the sole contingent taker under the trust document is a charity or charities, heirs-at-law must be added to take in the event one or more of the charities are not (or are deemed not) then in existence.

(7) If desired, an additional equitable adjustment to the Share B priority distribution described in Provision 5 can be made for the fact that the priority takers may receive their priority shares at a different income tax cost than the takers under Share A.

Drafting attorneys opting to employ the MAT also must be aware of the standard so-called "facilitation of payment" clause that is commonly included in most estate-planning attorneys' trust forms. These clauses authorize a trustee to retain assets that otherwise would be distributable outright to a beneficiary under a legal (or sometimes other) incapacity in further trust for the benefit of the beneficiary. The drafting attorney's standard facilitation of payment form therefore may need to be modified in light of the special MAT requirements.

For example, the clause cannot provide that the trust assets may be distributed in the trustee's discretion to another individual or entity to be held for the benefit of the beneficiary, other than to the beneficiary's legal guardian, conservator or custodian, or pass to the estate of the beneficiary at his death.

Income Tax Reporting

Shares A and B of the MAT should be taxed as separate trusts for federal income tax purposes, because their beneficiaries are not the same. The multiple-trust rule under Internal Revenue Code Section 643(f) should not apply to the MAT, because a principal purpose of the division of the MAT into Share A and Share B is not the avoidance of federal income tax. In fact, the IRS regulations themselves allow for the deferral of income tax on distributions to a trust over the oldest beneficiary of the trust's life expectancy, provided that the trust instrument is prepared properly. Although the MAT thus may save as much as $1,000 in federal income taxes per year, per trust (due to separate runs up the tax brackets for Share A and Share B), this saving obviously will largely be offset by the additional tax reporting cost for the two shares.

The funding of Share A with the right to receive the qualified employee plan or IRA benefits should not cause the acceleration of income in respect of a decedent (IRD) to the MAT, because the funding is accomplished in conjunction with the right of Share A to receive such amount "by bequest, devise or inheritance from the decedent."[9]

If a client is concerned that the MAT will generate more income tax (because of the compressed trust income tax brackets) than the standard conduit trust, it's a simple matter to mitigate this issue by granting the primary current beneficiary of the trust an IRC Section 678 withdrawal power over income of the trust that would otherwise be taxed in the maximum trust income tax bracket (subject to Section 2514's requisite 5 percent limitation to avoid annual taxable gifts). This system of taxing trust income to the primary current beneficiary of the trust, without actually requiring payment of the same to the beneficiary, also could result in a significant reduction in estate taxes at the beneficiary death.[10] Additionally, in many states this approach provides a greater level of asset protection than afforded by the conduit trust, with its attendant required outright distribution of the annual retirement plan and IRA benefit payments.

SPOTLIGHT

All the Rage—Montague Birrel Black's circa 1910 poster, "White Star Line / 'Olympic' and 'Titanic,'" 40 inches by 25 inches, sold for $36,000 at Swann Auction Galleries in New York on Nov. 18, 2009.

Non-qualified Annuities

Authorities and insurance companies differ regarding whether the rules applicable to qualified plans and IRAs payable to trusts also apply to non-qualified annuities payable to trusts. In the recently published book, *The Annuity Advisor*, authors John Olsen and Michael E. Kitces say they believe non-qualified annuities cannot be paid to a trust over the lifetime of the trust beneficiary, primarily because the IRS has not specifically ruled that they can, as the Service has done with qualified plans and IRAs.[11] According to these co-authors, because IRC Section 72(s)(2)(A) provides that stretched annuity payments after the death of the holder may only be paid "to (or for the benefit of) a designated beneficiary," and because Section 72(s)(4) in turn provides that, "[f]or purposes of this subsection, the term 'designated beneficiary' means any *individual* designated a beneficiary by the holder of a contract," currently only outright payments to individuals qualify for deferral under Section 72(s)(2)(A). (Emphasis added.)

The problem with this narrow analysis is that the IRC section on which these qualified plan and IRA trust regulations are based[12] employs language that is virtually identical to IRC Section 72(s)(2)(A). Both sections employ the phrase "payable to (or for the benefit of) a designated beneficiary." By choosing to narrowly define the circumstances under which non-qualified annuities payable to trusts can be deferred after the death of the holder, Olsen and Kitces are basically ascribing no meaning to the words "or for the benefit of," or to the fact that the overall structure of IRC Section 401(a)(9)(B) is virtually identical to Section 72(s). But these gentlemen are correct when they point out that, regardless of whether Section 72(s) permits stretched annuity payments to trusts, the issue is moot as to those insurance companies that do not allow payments to trusts to be stretched under their contracts.

So what does this discussion on non-qualified annuities mean for our drafting and our advice to clients relative to the payment of non-qualified annuities to trusts? The basic drafting rules should be the same as those for retirement benefits generally. But because not all insurance carriers permit the payment of non-qualified annuities to trusts on a deferred basis after the death of the holder, estate planners must study all relevant non-qualified annuity contracts of their clients to first ensure that payment of the non-qualified annuity to a trust after the death of the holder, on a deferred basis, will be permitted. If it is not, the planner must decide whether it's better to name outright beneficiaries (which may require the establishment of a court guardianship or conservatorship for minors or other beneficiaries under a legal incapacity) or pay the trust on a lump sum basis.

Regardless of the option chosen, the trust document should specify that annuity payments that may not be made to the trust on a deferred basis, pursuant to the annuity contract or otherwise (for example, under the tax law), should not be divided on the separate Share A and Share B MAT basis outlined in my section on the MAT provisions, because such division would not be necessary.

Full MAT Is Unnecessary When. . .

There are additional situations in which the MAT (or at least the full version of the same) may not be best for particular retirement benefits or non-qualified annuities. For example:

- When a company retirement plan does not permit payout other than on a lump sum (or five-year maximum) basis and also does not permit the required lump sum payment to be made to an inherited IRA, the MAT format would not provide any tax deferral benefit. Note, though, that if other retirement benefits or non-qualified annuities also are payable to the trust and if the payout of one or more of those other benefits or annuities is otherwise eligible to be made over the life expectancy of the trust beneficiary, the MAT format should not be eliminated merely because of the ineligible benefit or annuity.
- The MAT format is arguably also unnecessary when the client owns little in the way of retirement benefits and non-qualified annuities. Of course, "little" is subject to individual interpretation. Just bear in mind that the MAT's only complexity is it must contain

A MAT Sample Form

What you need to know

There are many ways to draft a modified accumulation trust. Here's one:

Separate Accounting for Retirement Arrangements

Except as otherwise provided in paragraph 3, below, if any trust hereunder shall have the right to receive retirement assets (as defined in ARTICLE _____, below) or the proceeds from the same, the trustee shall set aside and maintain as a separate share (hereinafter referred to as "Share A") from the remainder of the trust assets (hereinafter referred to as "Share B"), the trust's said right to receive all retirement assets, 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 the primary current beneficiary of the trust's surviving spouse (other than a surviving spouse who is no more than ______ years older than the primary current beneficiary of the trust), any creditor of the primary current beneficiary of the trust's estate, the primary current beneficiary's estate or any charitable organization. If, as a result of the application of the immediately preceding sentence, an otherwise permissible appointee or appointees in Share A has or have been eliminated, and if there is a percentage ceiling on the proportion of the original trust which the primary current beneficiary of the trust may appoint to said appointee or appointees, then said percentage ceiling shall be raised over the remaining principal and accrued income of Share B to the extent necessary to allow the primary current beneficiary of the trust to exercise his or her testamentary power of appointment over Share B in favor of said appointee or appointees who or which where eliminated as a permissible appointee or appointees in Share A, to the full extent of the ceiling over the original trust, recognizing that it may not be possible to fully achieve the percentage ceiling over the original trust.

2. For purposes of construing the provisions of the "CONTINGENT GIFT OF REMAINDER INTERESTS' under ARTICLE _____ hereof which will potentially apply at the termination of Share A, all potential heirs-at-law of the grantor who are older than the oldest living descendant of the grantor at the time of the grantor's death (assuming all such descendants were alive at the termination of the trust) shall be deemed to be deceased, and all non-individual potential takers shall be deemed to be not then in existence; PROVIDED, HOWEVER, if one or more descendants of the grantor's parents are living at time of the grantor's death, and if the application of the foregoing provisions of this paragraph 2 shall result in all such descendants who are also living at the time of the termination of the trust being deemed to be deceased, then the youngest such descendant of the grantor's parents who is living at the time of the grantor's death, as well as at the time of the termination of the trust, shall not be deemed to be deceased pursuant to the foregoing provisions of this paragraph 2, but all other heirs-at-law of the grantor shall be deemed to be deceased. If, as a result of the application of the immediately preceding sentence, an individual or individuals and/or a non-individual or non-individuals who and/or which would have otherwise received a portion of Share A as a contingent taker or takers under ARTICLE _____ hereof is or are deemed to be deceased or otherwise not then in existence, only these individual(s) and/or non-individual(s) (other than any ancestors of the individual takers in Share A pursuant to the immediately preceding sentence, who shall be deemed to be deceased) shall be deemed to be then living and/or designated for purposes of determining contingent takers of Share B under said ARTICLE _____ hereof, until such time as said individual(s) and/or non-individual(s) receive the same share(s) in Share B which they would have received in Share A had they not have been deemed to be deceased or not then in existence pursuant to the application of the immediately preceding sentence, after which point the provisions of said ARTICLE ____ hereof shall apply normally to the balance of Share B.

3. The foregoing provisions of this Section shall not apply to the trust if either of the following circumstances exists:

(A) (i) all retirement assets payable to the trust consist of either or both (I) nonqualified annuities which in the hands of the holder immediately before the grantor's death were beyond the annuity starting date or (II) other retirement assets which as to the owner or participant immediately before the grantor's death were after the required beginning date, and (ii) the primary current beneficiary of the trust is the grantor's spouse; or

(B) assuming the primary current beneficiary of the trust died immediately after the grantor's death, (i) no heir-at-law of the grantor who is living on the date of the grantor's death, as determined under ARTICLE ____ hereof, would be older than the grantor's oldest living descendant at the time of the grantor's death, (ii) no non-individual (including a trust) would be a potential taker under ARTICLE ____ , and (iii) neither any individual other than a descendant of the grantor nor any non-individual (including a trust) would be a permissible appointee over all or a portion of the trust assets under a testamentary power of appointment in favor of the primary current beneficiary 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.

Definition of Term "Retirement Assets"

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 a non-qualified annuity, 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 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; PROVIDED, HOWEVER, that any of the aforementioned assets shall not be deemed to be a "retirement asset" for purposes of this agreement if it is not permissible (other than as a result of this proviso), under the governing instrument or otherwise, to make payments to the trust in a form other than in a lump sum or over a maximum term certain (other than a maximum term certain based on the life expectancy of any of the grantor's descendants, of any heir of the grantor, or of any actual or hypothetical spouse of any of the grantor's descendants).

Endnote

1. The ancestors are still deemed to be deceased for two reasons. First, if they are not deemed to be deceased the result may be that some members of a particular generation may be included as contingent takers while others are not. Second, it makes more estate tax sense not to unnecessarily increase the taxable estates of individuals in older generations.

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two separate accounts, which likely will necessitate two separate sets of annual income tax return filings for the trust. And separate filings may produce some income tax benefit that could grow to be significant in the future. Planners should be mindful of the fact that what may be only a small retirement benefit or non-qualified annuity today may of course grow to be significant in the future.

- The MAT separate share approach also may not be necessary or advisable when (a) a married individual already is beyond the required beginning date under a retirement plan or IRA or beyond the annuity starting date under the non-qualified annuity; and (b) the person wants to pay the balance of his account after death to a trust for the benefit of his surviving spouse. Because the rules applicable to both retirement plans and non-qualified annuities permit the payments after the account owner's death to be made at least as rapidly as they were under the method of distribution being used as of the date of the account owner's death, and because in most situations the surviving spouse is close in age to the account owner, the MAT normally will generate very little additional tax benefit to the clients in such circumstances, and the separate Share A and Share B probably won't be helpful.
- The MAT typically will not be necessary or advisable if, assuming the lifetime beneficiary of the trust died immediately after the death of the grantor, (1) no outright remainderman of the trust would be a non-individual (including a trust) or an individual older than the grantor's oldest living descendant at the time of his death; and (2) neither any individual other than a descendant of the grantor nor any non-individual (including a trust) would be a permissible appointee of all or a portion of the trust assets under a testamentary power of appointment in favor of the lifetime beneficiary of the trust. Even the IRS' recent narrow PLR posture would not create a problem under these circumstances.

Finally, a much simpler form of MAT may be all that is required when a client has numerous children and grandchildren. In these fairly frequent situations, the chances are negligible that the contingent gift to heirs-at-law under the client's estate-planning documents will actually take effect. Thus, it's typically unnecessary under such circumstances to protect potentially disinherited heirs through the full Share A/Share B form of MAT. The "oldest beneficiary" issue can easily be addressed by providing in the contingent gift clause that all heirs-at-law older than the client's oldest living descendant at the time of the client's death are deemed to be deceased. Note, however, that when a client wishes to bestow upon the trust beneficiaries a limited testamentary power to appoint to potentially older individuals (including a surviving spouse) and/or charity, the full Share A/Share B form of MAT still would be required.

Fodder for Thought

Standard conduit trusts and accumulation trusts that are designed to provide maximum deferral of income taxes on qualified plans and IRAs as well as non-qualified annuity benefits and payments made payable to the trust after the participant's or account owner's death all have negative characteristics that will upset many estate-planning objectives of trusts that are for the benefit of a client's spouse and/or descendants. The MAT solves these concerns—while preserving the maximum possible deferral of income taxes on the qualified plan, IRA or non-qualified annuity benefits and payments made payable to the trust after the participant's or account owner's death. TE

Endnotes

1. *See* Private Letter Rulings 200610026 and 200843042. Note that I've deemed that earlier PLRs on a similar subject matter that were not applying the final Internal Revenue Service regulations, are not relevant to this discussion.
2. 67 Federal Register 18987-19028 (April 17, 2002). In addition, the "final" regulations have been modified in part. *See* 2004-26 Internal Revenue Bulletin 1082, 1098 (June 28, 2004).
3. Treasury Regulations Section 1.401(a)(9)-5, Q&A-7(b).
4. Treas. Regs. Section 1.401(a)(9)-5, Q&A-7(c)(1).
5. Treas. Regs. Section 1.401(a)(9)-5, Q&A-7(c).
6. Natalie B. Choate, *Life and Death Planning for Retirement Benefits: The Essential Handbook for Estate Planners*, Ataxplan Publications, (6th ed. 2006), at para. 6.3.04.
7. *Ibid*, at para. 6.3.06. *See also* PLR 200843042, to the same effect.
8. If the trust is for the benefit of a grandchild, in order to allow for a greater deferral (or "stretch") period, then the word "grandchild" should be substituted for the word "descendant" here.
9. IRC Section 691(a)(2).
10. *See* James G. Blase, "Recent Tax Acts Require Focus on Income Tax Aspects of Estate Planning," 30 *Estate Planning*, Vol. 12, at p. 617 (December 2003).
11. John Olsen and Michael E. Kitces, *The Annuity Advisor* at pp. 135-142 (2d ed. 2009).
12. IRC Section 401(a)(9).