

December 7, 2006

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Internal Revenue Service
CC:TEGE:EB:QP1
1111 Constitution Ave. NW
Washington, DC 20044

Re: Suggested change in Treas. Reg. Section 1.401(a)(9)-5, A-7(c).

Dear Attorney Vohs:

This letter suggests a modification of the Treasury's regulation regarding trusts as beneficiaries of retirement benefits. The purpose of the suggested change is to make the regulations more rational in their application and to carry out Congressional intent to treat a trust maintained for the benefit of one or more "designated beneficiaries" the same as individual designated beneficiaries are treated. See IRC Section 402(c)(11)(B), added by the Pension Protection Act of 2006, Section 829.

Under Reg. Section 1.401(a)(9)-5, A-7(c), a potential trust beneficiary is disregarded, for purposes of determining whether the trust satisfies the rules of Reg. Section 1.401(a)(9)-4, A-5(b), if such potential beneficiary's interest is contingent on the death of a prior trust beneficiary. The suggested modification is that a potential trust beneficiary should *also* be disregarded if such potential beneficiary's interest is contingent on a prior trust beneficiary's dying before the age of 46 years.

Background: The Required Minimum Distribution (RMD) Trust Regulations

The minimum distribution rules for qualified retirement plans are contained in IRC Section 401(a)(9). With some variations, the same rules apply to IRAs, 403(b) plans, and 457 plans. Section 408(a)(6); Section 403(b)(10); Section 457(b)(5), (d)(1)(B), (d)(2).

Required distributions are to be made “in accordance with regulations” issued by the Treasury. Section 401(a)(9)(A)(ii). The Treasury has issued three sets of regulations implementing the required minimum distribution rules. Proposed regulations were issued in 1987. Revised proposed regulations were issued in 2001. The current, “final,” regulations were issued in 2002.

Generally speaking, when the owner (“participant”) of a defined contribution retirement plan dies, leaving his plan benefits to a “designated beneficiary,” the benefits must be distributed in annual installments over the life expectancy of the designated beneficiary (or more rapidly). IRC Section 401(a)(9)(B); Reg. Sections 1.401(a)(9)-2, A-5; and 1.401(a)(9)-3, A-1(a).

A “designated beneficiary” is an individual entitled to receive benefits from the plan as a result of the participant’s death. IRC Section 401(a)(9)(E), Reg. Section 1.401(a)(9)-4, A-1, A-2. However, all three versions of the RMD regulations have permitted the beneficiaries of a trust to be treated as designated beneficiaries, even though the trust itself is the named beneficiary, if various requirements are met. If a trust meets these requirements (“see-through trust”) the beneficiaries of the trust are treated as if the participant had named them directly as his beneficiaries for certain aspects of the minimum distribution rules. Reg. Section 1.401(a)(9)-4, A-5. These “RMD trust rules” are intended to carry out Congressional intent that the life-expectancy-of-the-beneficiary payout method apply for benefits payable “to (*or for the benefit of*) a designated beneficiary,” not merely for benefits payable “to” a designated beneficiary. IRC Section 401(a)(9)(B)(iii)(I) (emphasis added).

Two types of trusts “pass” under the existing regulations

Two tests a trust must pass in order to qualify as a see-through trust are that all trust beneficiaries must be individuals, and that it must be possible to ascertain who is the oldest trust beneficiary. Reg. Sections 1.401(a)(9)-4, A-3, A-5(c) and 1.401(a)(9)-4, A-3(a). The life expectancy of the oldest trust beneficiary becomes the Applicable Distribution Period (ADP) for the benefits that are payable to the trust. Reg. Section 1.401(a)(9)-5, A-7(a)(1).

Taxpayers, practitioners, and plan administrators, to carry out their obligations under the tax laws, must apply the above two tests to trusts that are named as beneficiary of retirement benefits. A trust generally has multiple beneficiaries and/or potential beneficiaries, whose interests succeed each other in time and based on various contingencies. It is essential for the orderly administration of the tax laws that the Treasury provide clear and reasonable rules regarding which trust beneficiaries “count” in applying these tests.

The existing regulation’s rule regarding which beneficiaries “count” is clear but does not produce a reasonable result when applied to most trusts for youthful beneficiaries.

The existing rule is that, for purposes of the “all-beneficiaries-must-be-individuals” and “oldest-beneficiary’s-life-expectancy-is-the-ADP” rules, ALL trust beneficiaries other than “mere potential successor” beneficiaries “count.” A potential trust beneficiary who is a “mere potential successor” is disregarded in applying these tests.

The regulation gives two examples of mere potential successor beneficiaries that can be disregarded:

Conduit trust: If the trustee is required, by the terms of the governing instrument, to distribute forthwith, to an individual beneficiary, any distribution the trustee receives from the retirement plan during such individual’s life, then that individual is considered the sole beneficiary of the trust. This type of trust is sometimes called a “conduit” trust. Any beneficiary who may receive an interest in the trust property after the “conduit” beneficiary’s death is disregarded as a “mere potential successor” to the conduit beneficiary. Reg. Section 1.401(a)(9)-5, A-7(c)(3), Example 2.

Accumulation trust: If the trustee has the power to accumulate plan distributions, then two types of beneficiaries are “counted” (see Rules 1 and 2) and one type of beneficiary is disregarded as a “mere potential successor” (see Rule 3). Beneficiaries who “count” (or don’t) are:

Rule 1: Any beneficiary (called in this letter an “outright beneficiary” or “unlimited beneficiary”) who will receive the retirement benefits *outright immediately* upon the death of the participant, or *outright immediately* upon the death of a prior trust beneficiary, “counts” unless disregarded under Rule 3.

Rule 2: Any beneficiary who will receive a “limited” interest in the benefits “counts” as a beneficiary (i.e., is not disregarded), unless disregarded under Rule 3

Rule 3: Any beneficiary whose interest in the benefits is contingent solely on surviving an “outright” or “unlimited” beneficiary (see Rule 1) is considered a “mere potential successor” to the outright/unlimited beneficiary and is disregarded. Reg. Section 1.401(a)(9)-5, A-7(c)(3), Example 1; see PLRs 2004-38044, 2005-22012, and 2006-10026.

Thus, a trust that provides “Income to A, remainder at A’s death to B if living, otherwise to C” “passes” the trust rules as long as A and B are both individuals. It does not matter whether C is an individual; C is disregarded as a “mere potential successor” to B, because B is an outright (unlimited) beneficiary; B receives the trust property outright upon A’s death (if B is then living). The ADP for a retirement plan left to this trust will be the life expectancy of A or of B, whichever is shorter, regardless of what C’s life expectancy might be.

This test works properly in a trust that provides for beneficiaries who are all adults - for example, a trust for the benefit of the participant’s spouse (for life)

and of his/her adult children (who are to receive the trust property outright upon the spouse's death). However, the rule does not work properly when applied to typical trusts for *minor or other youthful beneficiaries*.

The problem in the current regulations regarding youthful beneficiaries

It is extremely common for parents and others who are leaving assets to minor children and other young individuals to delay the point at which such beneficiaries receive the assets outright until an age that the benefactor considers sufficiently mature to handle an inheritance. Thus, it is extremely common for assets to be left in trust for the benefit of a child, grandchild, or other beneficiary subject to the condition that the beneficiary may not take outright control of the asset until he or she reaches a certain age, such as 25, 30, 35, or even 40 or 45 years.

This type of provision has nothing to do with saving taxes. It is intended solely to protect the beneficiary from misspending the inheritance due to a lack of maturity. Delayed distribution to a more mature age is so common as to be universal in the experience of estate planners; in fact, the parent who wishes his or her child to have outright control of funds at age 18 or 21 is the exception.

However, the current RMD trust rules treat a distribution that is delayed to a certain age the same as any other delayed distribution: If a beneficiary's ownership of the trust assets/benefits is delayed for any length of time, such beneficiary is not considered an outright (unlimited) beneficiary, and accordingly the contingent successors to that beneficiary are *not* disregarded as "mere potential successors." They must be "counted" in testing the trust under the RMD trust rules.

For example, suppose a trust provides "the trustee will pay income and/or principal of the trust to or for the benefit of B for B's health, education, and support, until B reaches the age of 25 years, at which time the trust shall terminate and be distributed outright to B; but if B dies before reaching the age of 25 years, the trust property passes to C." On the participant's death, both B and C are living. B is 20 years old. Under the current IRS interpretation, *both B and C* "count" as beneficiaries of the trust. B is not considered an "outright" (unlimited) beneficiary because his distribution is delayed until he reaches age 25, and accordingly C cannot be disregarded as a "mere potential successor." Suppose C is 90 years old when the participant dies. Under the current IRS interpretation, the trust beneficiaries are B and C, of whom the older is C, so C's life expectancy (which is only five years) becomes the ADP for the benefits. See PLR 2002-28025.

Another example: The participant leaves his benefits to a trust that provides "Income to my spouse, A, for life, principal to my child B on A's death, provided, that if B has not yet attained the age of 35 years at the death of A, the property shall be held in trust for B until he reaches age 35, with the trustee using

the income and/or principal for B's benefit in the meantime; and if B does not survive A, or dies before reaching the age of 35, the trust property shall pass to C." At the participant's death, A (age 45), B (age 20), and C (age 90) are all living. Because B would not receive the benefits outright immediately upon A's death, B is not considered an "outright beneficiary," and so C cannot be disregarded as a mere potential successor. C must be counted as a beneficiary of the trust and C's life expectancy then becomes the ADP for the benefits, because C is the oldest countable beneficiary. See PLRs 2006-10026, 2006-10027. However, the actuarial likelihood that C would outlive A and B is almost zero.

This rule produces absurd results - not just in rare cases, but in almost all cases where it applies. PLR 2002-28025 (the first IRS pronouncement in which this interpretation became clear) is typical: The participant died leaving her IRAs to a trust for the benefit of her two minor grandchildren. They were the sole beneficiaries of the trust during their lifetimes, with the trustee having discretion to use the funds for the grandchildren's support, health, and maintenance. The grandchildren would attain outright ownership of the trust assets and IRAs upon reaching age 30. However, if they both died before reaching that age, the trust would be distributed to contingent beneficiaries who were much older. The oldest contingent beneficiary was age 67 when the participant died. The IRS ruled that the 67-year-old's life expectancy was the ADP for the trust.

This result is absurd, because there is a greater than 98 percent likelihood that a teenage beneficiary will reach age 30. The actuarial likelihood that the 67-year-old contingent remainder beneficiary would outlive two teenagers is less than one percent. Thus, the IRS rule in this case treats, as a beneficiary, someone who is *extremely unlikely to ever receive any share of the retirement benefits*. Yet this absurd result will prevail whenever individuals leave retirement benefits to a typical trust for a youthful beneficiary, even though the youthful beneficiary is clearly intended to receive the benefits, and *will* receive outright distribution at a more mature age - an age that the young beneficiary is extremely likely to attain.

Why the rule should be changed

Any rule that almost always produces absurd results causes taxpayers to lose respect for the IRS and for our tax system. As applied to young beneficiaries, the current rule thwarts Congress's intent that the life expectancy of the *real* beneficiary (not that of some remote potential beneficiary, who is unlikely ever to receive a dime from the plan) should be the ADP for the benefits.

The current rule is a trap for the unwary. Participants who leave benefits to a typical trust for their minor children will cause an unintended acceleration of distribution of the benefits, with a resulting financial loss to the youthful beneficiaries they are trying to provide for.

It also creates a nightmare for the wary: Participants trying to provide for young beneficiaries, if they are aware of the rule and desire to assure the

availability of the life expectancy payout for their beneficiaries, are presented with several unattractive choices. They can leave the benefits to a conduit trust for the minor; however, this approach makes no sense, because the whole point of leaving assets in trust for a minor beneficiary is to protect the minor during his period of incapacity and during the period of young adulthood when his ability to handle money is questionable. But the only other options parents have under the existing regulations are to name outright remainder beneficiaries who are younger than the intended “real” trust beneficiaries (even though those young contingent remainder beneficiaries may not be the real objects of the parents’ bounty), or to forego the benefits of the life expectancy payout of the retirement benefits over their children’s life expectancies.

Change the rule so that interests worth less than 5% are disregarded

The rule can easily be fixed by treating a *delayed*-outright-distribution gift to a young beneficiary exactly the same as an *immediate*-outright-distribution gift, so long as the outright distribution is not delayed beyond age 45. A beneficiary who will be entitled to outright distribution of the benefits upon reaching any age that is younger than 46 should be treated as an “outright” (unlimited) beneficiary. Any potential remainderman who will receive the benefits only if the young beneficiary dies before reaching the specified age should be disregarded as a mere potential successor. The effect of such a rule would be to ignore a contingent remainder interest that has an actuarial value of less than approximately five percent, since an individual younger than age 45 has at least a 95 percent chance of reaching age 45.

In other contexts, Congress and the IRS have created rules under which insignificant interests and possibilities are ignored, with “significance” being determined using a bright line numerical cutoff. In both Congressional and Treasury rules, the dividing line between significant and insignificant interests is generally five percent; interests less than that amount are deemed insignificant and are disregarded. See Attachment A for seven examples of this approach in other contexts in the Code and regulations.

While the concept of disregarding interests worth less than five percent is sensible and consistent with many other Code provisions in various contexts, any test that requires actuarial valuation of trust interests is likely to be complex beyond the capabilities of the average plan administrator or estate planner. What is needed in the RMD area is a simple bright line test that produces the proper result in the majority of cases.

The IRS could follow Congress’s example and adapt the rule of IRC Section 2632(c)(3)(B)(i) (see Attachment A, Item # 2) to the minimum distribution situation by treating a beneficiary who will be entitled to outright distribution of the benefits before age 46 as an outright beneficiary. Any beneficiary who will be entitled to the benefits only if *another* beneficiary dies before attaining an age that is younger than age 46 would accordingly be

disregarded as a mere potential successor to such other beneficiary. This gives a bright line, easily applied test that produces the result of disregarding beneficiaries whose likelihood of acquiring the benefits is less than approximately five percent.

Had this test been used in PLR 2002-28025, the 67-year old contingent beneficiary under the trust would have been ignored, because he would take a share of the benefits only if the other (primary) trust beneficiaries died before reaching age 30. This would have enabled the trust to use the life expectancy of the older of the two minor primary beneficiaries to measure required distributions rather than the 67-year-old's. This result would have been more appropriate and more consistent with Congressional intent, since it is clear that the donor's intention was to name her grandsons as the sole beneficiaries of her retirement plans; older contingent beneficiaries were named in the trust only because it is essential, in drafting a trust, to assure that the trust property is properly disposed of even in case of a remote contingency such as the deaths of two teenage beneficiaries prior to reaching age 30.

Respectfully submitted,

Natalie B. Choate

Attachment A

Here are examples from the Code and Regulations in which Congress and/or the Treasury and IRS allow an interest worth less than five percent to be ignored:

1. A retirement plan participant who owns five percent or less of the plan sponsor (employer) is eligible for the deferred "required beginning date" of Section 401(a)(9)(C)(ii), just like any nonowner employee, while an individual who owns more than five percent of the sponsoring employer is not eligible for this advantage.
2. Section 2632(c) generally provides for automatic allocation of GST exemption to potentially generation-skipping trusts. However, Section 2632(c)(3)(B)(i) provides that GST exemption will *not* be allocated to a trust if more than 25 percent of the trust is to be distributed outright to nonskip persons before the age of 46. There is approximately a 95 percent likelihood, at birth, that a person will live to age 46. Since, as to a substantial portion of the trust, there is no more than a five percent likelihood that such portion will be part of a generation-skipping transfer, Congress decrees that such a trust does *not* attract the automatic allocation of GST exemption.
3. Section 2037(a) generally requires inclusion, in the donor's gross estate, of property the donor has transferred during life if (among other things) the donor retained a reversionary interest in the property; however, the asset is *not* included in the donor's estate under this section if the value of the donor's reversion, immediately before his death, is five percent or less of the value of the asset.
4. Gifts to a charitable remainder annuity trust that meets the requirements of Section 664 generally qualify for income, gift and estate tax charitable deductions. However, in Rev. Rul. 77-374 (1977-2 C.B. 329) the IRS decreed that the contribution deduction would *not* be allowed if there were a greater than five percent chance that the assets of the CRAT would be exhausted by the annuity payments prior to the end of the life interest. (This Revenue Ruling has since been made obsolete by a Code amendment.)
5. Section 318 dictates that ownership of stock by a trust beneficiary is generally attributed to the trust for various purposes, "unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of this clause, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is five percent or less of the value of the trust property." Section 318(a)(3)(B)(i).

6. Under Section 673(a), the grantor of a trust is treated, for income tax purposes, as the owner of a trust if he has retained a reversionary interest that is worth more than five percent of the total trust value (at the inception of the trust). If the value of his retained reversionary interest is less than five percent, Section 673(a) is not triggered.
7. Allowing a power of appointment to lapse would normally be considered a gift to the takers in default of exercise. To avoid subjecting trivial amounts to gift tax, Section 2041(b)(2) provides that the lapse of a power is treated as a gift “only to the extent that the property, which could have been appointed by exercise of such lapsed powers, exceeded in value, at the time of such lapse, the greater of” \$5,000 or five percent of the aggregate value of the property available for the satisfaction of the power.