

“FUNDING TRUSTS”

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*Wills, Trusts & Probate Committee
of the Lake County Bar Association
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1. BASIC ISSUES

a. IMPORTANCE OF FUNDING LIVING TRUSTS

i. Avoidance of Probate;

ii. Estate Tax Planning - ensuring that there are enough assets in the 1st to die's estate to utilize the decedent's estate tax exclusion amount (currently \$1 million; \$1.5 million for 2004-2005; \$2 million for 2006-2008; \$3.5 million for 2009; estate tax repeal in 2010, with the rather dramatic reimposition of the estate tax in 2011 with a \$1 million estate tax exclusion amount);

iii. Assets Distributed as Client Intends?

(1) Trust provisions do not control the disposition of joint tenancy assets or assets held with beneficiary designations to non-trust beneficiaries;

(2) *Apportionment of Taxes & Expenses* - most trusts provide that taxes & expenses are paid from the residue. Such "burden on the residue" draftsmanship typically presents a problem when substantial non-probate assets pass to different beneficiaries than the trust assets.

Example: Hal dies in 2004 with a \$3 Million taxable estate triggering \$705,000 in estate taxes. His assets consist of (i) trust assets of \$1.5 million, payable to his daughter as trust remainderman; and (ii) a \$1.5 million insurance policy payable to his son. Under a "burden on the residue" apportionment clause (without any trust directive apportioning estate taxes to insurance policies), the \$705,000 estate tax is paid out of the trust residue, leaving daughter with only \$795,000, and son with \$1.5 million;

iv. Spousal Rights - Assets held in a Living Trust generally are not subject to the statutory rights of a surviving spouse to renounce the will. Johnson v. LaGrange State Bank, 73 Ill. 2d 342, 283 N.W. 2d 185 (178);

v. Recommendation - 3 column worksheet showing assets in (i) husband's name; (ii) wife's name; and (iii) joint tenancy. Considering transferring property from one spouse to another or severing jointly held assets to fund the credit shelter amount for both spouses (discussed below);

vi. Miscellaneous

(1) Funding the Living Trust for Payment of Estate taxes;

(2) Protection of the Grantor in the event of incapacity;

(3) If the attorney does not help out by preparing the necessary trust funding documents, the assets tend not to get transferred.

(4) Special Property Power of Attorney - permits trust funding if Grantor is incapacitated.

(5) **SEE EXHIBIT "A" FOR SAMPLE SPECIAL PROPERTY POWER OF ATTORNEY FORM**

b. **ATTORNEY FEE ARRANGEMENTS FOR TRUST FUNDING**

i. Flat Fee - documents and trust funding included in one fee;

ii. Two separate engagements - one fee for documents; one fee for trust funding;

iii. Hourly rate for trust funding;

iv. Hybrid - funding of real estate included in flat fee, funding letter to clients for other assets;

v. Menu Price" for each transfer (i.e., \$100 per insurance beneficiary designations; \$150 for each real estate deed...);

vi. **SEE EXHIBIT "B" FOR SAMPLE CLIENT FUNDING LETTER.**

c. **GENERAL TITLING RULES**

i. Normal titling convention -

"John Smith, trustee of the John Smith Declaration of Trust dated November 21, 2003"

ii. Title convention for assets the owner may not collect (i.e, life insurance, IRAs, pension plan benefits)

"The then acting trustee of the John Smith Declaration of Trust dated November 21,

2003"

iii. Grantor's social security number typically constitutes trust identification number

(1) See Regulation Section 1.671-4(b)(2)(i)(A).

iv. The Dilemma of "Splitting" Assets between Husband's and Wife's Living Trusts to Accomplish Estate Planning Goals.

(1) *Easy to say, often hard to do;*

(2) *"Solutions"*

(a) Joint Trusts to the rescue? See PLR 200100021. Presume \$1.5 million in total assets contributed ½ by each spouse. Joint trust (with credit shelter trust) gives 1st spouse to die a general power of appointment over the entire trust. Husband dies. Result: Credit Shelter Trust funded with \$1 million, even though \$250,000 of such amount contributed by surviving spouse.

(b) Brokerage accounts and other assets may be able to be owned as 50% tenants in common between husband's and wife's respective Living Trusts;

(3) *Tax Basis Step-Up Considerations*

(a) Assets held in joint tenancy receive a 50% step-up upon 1st to die;

(b) Assets (non-pension) in Living Trust receive a 100% basis step-up upon death of Grantor;

(c) Problems. For example, funding assets in the wife's trust to accomplish proper estate tax funding, may have negative income tax consequences if the husband dies 1st (i.e., no step-up since the assets are in the wife's trust who is still alive versus 50% step-up if the property remained in joint tenancy). Solution: split assets 50% between husband's trust and wife's trust to prevent "loss" of basis step-up (at the expense of estate planning and "underfunding" wife's trust?).

(4) *Marital Property Issues.* Transferring property from one spouse to another, or in severing jointly held property for estate tax planning may constitute a gift converting marital property into non-marital property.

(a) Does Consent stating property funded in wife's trust remains Marital Property (rather than Non-Marital Property) work?

- v. If Requested, should a full copy of the Trust be delivered to the Transfer Agent?
 - (1) Try providing an “excerpt” of the trust which includes only the cover page, signature page and trust provisions listing the trustees;
 - (2) **SEE EXHIBIT “C” FOR SAMPLE “CERTIFICATE OF TRUST EXISTENCE AND AUTHORITY”** (IICLE Revocable Grantor Trusts, Chapter 8). Good idea; does not work with all transfer agents.
- vi. Lack of Uniformity among Transfer Agents.

2. REAL ESTATE

- a. **QUIT CLAIM DEED**.- not preferred: does not list the powers of the trustee and hypothetically the title company may require that the trust agreement (which is presumably notarized) be recorded;
- b. **DEED IN TRUST - preferred**. Since the powers of the trustee are set forth in the deed itself, the trust will not have to be recorded. Although in practice most title companies still ask to review the trust at closing, there should be no need to look into the terms of the trust agreement.
- c. **GRANTING LANGUAGE:**
 - i. Single Grantee:

"JOHN SMITH, 95 xxxxxxxxxxxx Road, Lake Forest, Illinois, Trustee, under the JOHN SMITH Declaration of Trust dated November 21, 2003 and to all and every successor or successors in trust under such trust agreement."
 - ii. Husband/Wife Grantees:

“-an undivided one-half (½) interest, as tenants in common, to JOHN SMITH, 95 xxxxxxxxxxxx Road, Lake Forest, Illinois, Trustee under the JOHN SMITH Declaration of Trust dated November 21, 2003 and to all and every successor or successors in trust under such trust agreement;

“-an undivided one-half (½) interest, as tenants in common, to JANE SMITH, 95 xxxxxxxxxxxx Road, Lake Forest, Illinois, Trustee under the JANE SMITH Declaration of Trust dated November 21, 2003 and to all and every successor or successors in trust under such trust agreement.”
- d. **MORTGAGED REAL ESTATE - Triggering of “Due on Sale” clause?**
 - i. Generally, Federal law prohibits the enforcement of a “Due on Sale Clause” for transfer of residential property to trust with four or fewer units in which the

borrower is and remains a beneficiary. *Garn-St. Germain Depository Institutions Act of 1982*, Section 1701j-3 of Title 12 of the U.S. Code. Also see also 12 C.F.R. 592.5(b)(1)(vi).

- ii. In all other cases, including commercial property, obtain the consent to the transfer from the bank

SEE EXHIBIT “D” for Sample Consent Form

- (a) If consent isn't obtained, so what? ...lender has to “catch” you and presumably one could refinance...interest rate risk if current rate is higher than loan rate?

- iii. *Refinancing Difficulties?*

- (a) Some lenders still do not understand Living Trusts and will require the owners to reconvey the property back to themselves, with a subsequent transfer to trust. (Technically, this re-deeding is a “break” in title insurance coverage requiring a title endorsement. See discussion below).

e. **TITLE INSURANCE PROBLEMS?**

- (1) Technically, transfer to Living Trust is a “break” in insurance coverage and one should obtain an endorsement changing the named insured to the Living Trust.
- (2) In practice, title insurance company is not informed of transfer to Living Trust and the author is not aware of any cases where coverage has been denied.

f. **STATE AND LOCAL RULES**

- (1) Recorder of Deeds filing fees;
- (2) Cook County
 - (a) “Grantor/Grantee Affidavit”

SEE EXHIBIT “E” for Sample Grantor/Grantee Affidavit for Assigning Cook County Real Estate to Trust

- (3) Various municipal (i.e., Chicago) transfer forms.

- g. **TRANSFER TAX DECLARATIONS** - if the town in which the real estate is located has a transfer tax; an exemption form may have to be completed and submitted to the town for an “exemption stamp” which is affixed to the deed. in Lake County, only Highland Park, Buffalo Grove, Lincolnshire, Mettawa, Fort Sheridan and North Chicago have local transfer

taxes

- h. **OUT-OF-STATE TRANSFERS** - Proceed at your own Risk!!! (malpractice concerns).
- i. **PROPERTY INSURANCE** - contact the homeowner's insurance company to list the trust as an additional insured. In practice, rarely done.
- j. **LAND TRUSTS** - consider naming the land trust as beneficial owner.
- k. **ENVIRONMENTAL LAW ISSUES FOR THE TRUSTEE**. If a person other than the Grantor is to act as trustee,
 - i. "Phase I" environmental audit?;
 - ii. Consider trust provisions to protect the trustee, such as reimbursement from the trust assets for any environmental claims and the right to be indemnified by the trust beneficiaries with respect to any environmental law claims;
 - iii. Arguably, bequest of tainted real estate to a beneficiary under a Will offers more protection than a distribution of real estate from a Living Trust.
- l. **MISCELLANEOUS**
 - i. Condominiums - consent of condo board?
 - ii. Co-operatives - assignment of shares of stock to the trust, with lease assigned to the trustee;
 - iii. Trust provision defining rights of surviving spouse to reside in residence?

Sample Language:

To permit me and my spouse, or either of us, to occupy as a home, rent-free, any residence which may be a part of any trust. All taxes and expenses of maintenance, management, and protection of the residence shall be paid by the Trustee, but the amount of each payment shall be limited to the trust's percentage of ownership in the residence. The Trustee shall not transfer or lease such residence without my prior written consent, if I am able to give or withhold consent. If I am not living, or if I am not able to give or withhold consent, and my spouse is then living, the Trustee shall not transfer or lease it without the prior written consent of my spouse, unless the Trustee determines that my spouse is unable to give or withhold consent. If such residence is sold, my spouse may further direct to the Trustee, in writing, to apply any portion or all of the proceeds from the sale of such a residence to the purchase of a replacement residence, to be held upon the same terms as the residence originally held. Moreover, the trustee shall not be liable to any person at any time interested in the income from or principal of any trust by reason of having retained such residence or interest therein as principal of such trust, or for any loss or damage to any such residence or interest therein, whether or not such loss or damage shall result from such occupancy or use and whether or not such residence or interest therein shall have been insured adequately or at all against loss or damage.

3. **TANGIBLE PERSONAL PROPERTY**

a. **BY ASSIGNMENT FORM.**

SEE EXHIBIT “F” FOR SAMPLE ASSIGNMENT FORM.

b. **ASSIGNMENT WITHIN TRUST INSTRUMENT** - Sample language (adapted from IICLE “Illinois Estate Planning Forms and Commentary Handbook.”)

FOURTH: GIFTS OF TANGIBLE PERSONAL PROPERTY. I hereby assign all of my clothing, jewelry, personal effects, and other tangible personal property to this trust. On my death, the trustee shall distribute the following gifts of tangible personal property from the trust estate:

SECTION 1: By Written Direction. The trustee shall make gifts of tangible personal property as I direct by any written instrument signed by me. “Tangible personal property” means all personal and household effects, jewelry, automobiles, collections, and other tangible personal property that I own at my death or that is then included as part of the trust estate (including insurance thereon but excluding business use property, precious metals, and unset gems). I may from time to time amend or revoke the written instrument, and any subsequent instrument shall control to the extent it conflicts with prior ones. Any decisions made in good faith by the trustee in distributing tangible personal property shall not be subject to review, and the trustee shall be held harmless from any cost or liability as to those decisions. I shall be deemed to have left only those written instruments that the trustee is able to find after reasonable inquiry within 60 days after my death.

SECTION 2: Tangible Personal Property Not Disposed of by Written Direction. I give all tangible personal property not otherwise effectively disposed of to my spouse, if my spouse survives me, or if my spouse does not survive me, in shares of equal value to the children of my spouse and me who survive me (to the exclusion of the descendants of any child who does not survive me), to be divided among them as they agree or, if they cannot agree within 60 days after my death, as the trustee determines. If a child is a minor at the time of distribution, the guardian of or person in loco parentis to the child shall represent him or her in the division of the property, receipt for and hold his or her share or sell all or any part of it, and deliver the share or proceeds to the child when he or she reaches majority, or earlier if the guardian or person considers it to be for the child's best interests.

4. **PUBLICLY TRADED STOCKS AND BONDS** (*Two Options*)

a. **ESTABLISH A BROKERAGE ACCOUNT**

- i. Have the client's broker do the work by establishing a brokerage account titled in the name of the trust and transferring all investments to such account;
- ii. Advantages of having a brokerage account;
 - (a) Simplification of purchases and sales;
 - (b) Dividends are tracked and deposited directly into a money market account;
- iii. Convert an Existing Brokerage Account to a Trust Account
(Typically requires Letter of Direction; New Account Application; Copy of Trust Instrument; Certification of Trustee Powers; however requirements vary greatly among brokerage companies);

SEE GROUP EXHIBIT "G" FOR SAMPLE LETTERS OF DIRECTION/BROKERAGE FIRMS

b. **RE-REGISTER STOCK WITH THE TRANSFER AGENT;**
CAUTION, CAUTION, CAUTION - USUALLY A LOT OF WORK!!!

i. Identify the Transfer Agent and Determine Procedure

| | |
|---|-----------------------|
| <i>Computershare Investor Services</i> | <i>1-312-588-4131</i> |
| <i>Computershare Trust Company</i> | <i>1-800-962-4284</i> |
| <i>Continental Stock Transfer</i> | <i>1-212-509-4000</i> |
| <i>EquiServe general</i> | <i>1-781-575-2000</i> |
| <i>EquiServe - Boston</i> | <i>1-800-730-4001</i> |
| <i>EquiServe - New Jersey</i> | <i>1-800-446-2617</i> |
| <i>EquiServe - Fairway</i> | <i>1-800-498-8861</i> |
| <i>EquiServe - closed end mut funds</i> | <i>1-800-426-5523</i> |
| <i>EquiServe - Bonds</i> | <i>1-800-426-5523</i> |
| <i>Fifth Third Bank</i> | <i>1-800-972-3030</i> |
| <i>Illinois Stock Transfer Company</i> | <i>1-800-757-5755</i> |
| <i>LaSalle National Bank</i> | <i>1-800-246-5761</i> |
| <i>Mellon Investor Services</i> | <i>1-800-205-7699</i> |
| | <i>1-800-275-2048</i> |
| <i>National City Bank</i> | <i>1-800-622-6757</i> |
| <i>Registrar & Transfer</i> | <i>1-800-368-5948</i> |
| <i>StockTrans, Inc.</i> | <i>1-800-733-1121</i> |
| <i>SunTrust Bank</i> | <i>1-800-568-3476</i> |
| <i>The Bank of New York</i> | <i>1-800-432-0140</i> |
| <i>The Bank of New York - Bonds</i> | <i>1-800-548-5075</i> |
| <i>U.S. Stock Transfer Corporation</i> | <i>1-818-502-1404</i> |

Major transfer agent Web Addresses:

<http://www.equiserve.com/>

<http://www.melloninvestor.com/>

<http://www.bny.com/>

- ii. Determine if you are dealing with stock certificates, book entry certificates (i.e., dividend reinvestment plan), or both;
- iii. If transferring stock to a Living Trust from a probate estate OR joint tenancy, two-step transfer approach (1st to Grantor, then to Grantor's Living Trust) may be recommended by transfer agent. Try to get transfer agent to agree to one-step transfer to Grantor's Living Trust.
- iv. Title to dividend reinvestment accounts (i.e., book entry shares) must be separately transferred to trust - even if the stock held in certificate form has been transferred to trust;

- v. "Lost" Stock Certificates - request a "lost certificate" package from the transfer agent whereupon a surety bond will be required to be purchased for 1%-3% of the security value. Usually a two-step process i.e., the stock is reissued in the name of the owner; then the above steps must be taken to transfer the certificates to trust;
- vi. Transfer of Shares owned by decedent:
 - (a) transfer via probate process;
 - (b) transfer via small estates affidavit (if probate estate less than \$50,000);
 - (c) transfer via obtaining surety bond (if estate over \$50,000 and probate is to be avoided).
- vii. Typical Transfer Agent Transfer Requirements:
 - (1) Letter of Direction *signature guaranteed OR notarized*;
 - (2) Stock Power *signature guaranteed*;
 - Caution: Do not endorse the stock certificate, because if you make a mistake, white-outs and erasers may not be accepted by the transfer agent, thereby requiring an "erasure guarantee" from a surety company.
 - (3) Form W-9;
 - (4) Affidavit of Domicile (if deceased owner on title);
 - (5) Copy of Trust (try to get away with tendering 1st page, trustee page and signature page);
 - (6) Cover Letter Explaining Transfer;
 - (7) Mail package to transfer agent by certified mail, return receipt requested; or registered, insured mail (insure for 3% of the value of the stock to cover the cost of a surety bond if the stock is lost).

SEE GROUP EXHIBIT "H" FOR SAMPLE FORMS RELATING TO TRANSFER AGENTS

5. **CLOSELY HELD STOCK**

- a. **ENDORSEMENT OF STOCK CERTIFICATE** on back, with issuance of new certificate (*keep accurate stock transfer book*);

- b. **DOES A BUY-SELL AGREEMENT RESTRICT TRANSFER?** (If “yes”, review agreement and obtain consent of other shareholders or amend Buy-Sell Agreement to permit transfer to Living Trust);

Sample Language in Buy-Sell Agreement Permitting Transfer to Living Trust

Permitted Transfers to Shareholder’s Living Trust. Notwithstanding the above, any Shareholder may transfer his LLC Interests to a trustee or trustees of a trust which qualifies as a Grantor Trust taxable to the Shareholder under Code Sections 671 through 677.

c. **S CORPORATION ISSUES AFTER DEATH OF GRANTOR:**

- i. No problem during life of Grantor (a “grantor trust” is an eligible S Corporation Shareholder under Code Section 1361(c)(2)(A)(i);
- ii. Problem after death of Grantor
 - (1) generally a two-year “grace period” that a non-qualifying trust (i.e., a “spray” trust, such as the typical Family Trust) can hold S stock;
 - (2) A Marital Trust generally qualifies as a Qualified Subchapter S Trust (“QSST”) which can hold S stock without voiding the S election;
 - (3) Electing Small Business Trust. See Code Section 1361(e). (major cost - election causes trust income to be taxed to shareholders at highest income tax rates);
 - (4) Amend the trust so it qualifies as a “QSST” (income distributable to one beneficiary). See Code Section 1361(d)(3).
 - (5) Sample QSST “Reformation” Language in Trust Boilerplate

SECTION 13: Authorization to Trustee to Modify Trust to Comply with QSST Requirements. If the trustee of any trust under this instrument deems it to be in the best interests of the primary beneficiary of such a trust to treat the trust as a Qualified Subchapter S Trust, in order to enable the shareholders of a corporation to elect to treat the corporation as an S corporation under the Internal Revenue Code as then in effect, the trustee, in a written document, shall modify the terms of that trust from time to time, effective as on the date set forth in the document, as follows:

1. During the life of the primary beneficiary, such person shall be the only income beneficiary of the trust, and as long as the trust holds S corporation stock, all the net income shall be distributed to the primary beneficiary at least annually;
2. Any principal distributed during the life of the primary beneficiary may be distributed only to that person;
3. The income interest of the primary beneficiary shall terminate on the earlier of the beneficiary's death or on the termination of that trust;
4. Upon the termination of the trust during the life of the primary beneficiary, the trust shall

distribute all of its assets to such beneficiary; and

5. If it is necessary or desirable, in the trustee's discretion, in order to effect my intent under this clause as to one or more separate trusts under this instrument, to divide, in such proportions as the trustee shall determine, considering the purposes for which principal is payable, a trust which has more than one beneficiary to whom income or principal may be paid into separate trusts, each named for a beneficiary, having only that beneficiary as a permissible recipient of income and principal payments;

6. The trustee shall further modify the terms of such trust if, and only to the extent that, such further modification is required to qualify the trust as a Qualified Subchapter S Trust.

The following provisions shall apply to this provision: (a) It shall be liberally construed to effect my intent; (b) No right, power, or discretion granted by this instrument or by law shall be exercised so as to cause an unintentional termination of an S corporation election previously made, except that this provision shall not be construed as restricting the trustee or a beneficiary of such a trust from intentionally electing to terminate, or not to qualify for such status, if such discretion is granted under applicable tax laws; (c) Any election shall be revocable unless otherwise provided by the trustee; and (d) The provisions of this clause shall not be construed as permitting the trustee to deviate from the other terms of this instrument.

- d. Professional Corporations. Can a Living Trust own stock in a Professional Corporation (i.e., registered under the Illinois Department of Public Regulation)? See 805 ILCS 10/11 which provides that only a licensed professional can own stock in a professional service corporation, so it does not appear possible to assign such stock to a Living Trust.

6. **LIMITED LIABILITY COMPANIES AND LIMITED PARTNERSHIPS**

- a. **REVIEW UNDERLYING DOCUMENTS** to determine the circumstances under which an assignment may be made (i.e., consent of part or all of the other partners/members?);
- b. ***SEE EXHIBIT "I" FOR SAMPLE PARTNERSHIP ASSIGNMENT FORM***

7. **GOVERNMENT SECURITIES AND SAVINGS BONDS**

- a. **TREASURY BILLS - Treasury Direct Account** opened in the name of the Living Trust:
- i. Form PD5182
- b. **SAVINGS BONDS** titled in the name of the Living Trust:
- i. Form PD F 1851 E
- c. **OTHER U.S. REGISTERED SECURITIES:**
- i. Form PD 1832
- d. **OBTAIN ABOVE FORMS** by calling Federal Reserve Bank or go online to:

8. **BANK ACCOUNTS**

a. **NEW SIGNATURE CARD;**

b. **COPY OF TRUST** (or trust "excerpt");

c. **PROBLEMS**

- i. *Direct Deposit problem.* If a "new" account is opened, direct deposits (i.e., social security, pension payments etc.) must be transferred to new account;
- ii. *Early Withdrawal Penalty problem.* For Certificates of Deposit, make sure that bank will not impose an early withdrawal penalty. Usually only an issue if the social security number (SSN) changes - i.e., from a joint account listing husband's SSN, to a trust account listing wife's SSN;
- iii. *Checks can stay exactly the same.* Each checking account should continue to have the client's name printed in the upper left-hand corner and clients should continue to be able to write checks by signing your name only; the words "Trust" and "Trustee" do not need to appear anywhere on the checks.

9. **LIFE INSURANCE**

a. **REQUEST CHANGE OF BENEFICIARY FORM;**

Sample Designation:

"John Smith, Trustee of the John Smith Declaration of Trust dated November 21, 2003"

- b. **REQUEST CHANGE OF OWNERSHIP FORM** (optional) if desired to have life insurance policy controlled by the trustee (i.e., upon incapacity, the trustee will have access to cash values). Typically not done for Living Trust funding - upon incapacity, agent under Property Power of Attorney can transfer policy to trust.

10. **MISCELLANEOUS ASSETS AND ISSUES**

- a. **SOLE PROPRIETORSHIP** - cannot be transferred to trust;

- b. **AUTOMOBILES** - best to place in trust when purchasing automobile, although typically automobile transfers are not common. Forms can be obtained from Secretary of State office. For efficiency, consider hiring a private service i.e., Central License Service (847) 926-0810.

11. **IRA'S & QUALIFIED RETIREMENT BENEFITS**

a. **FINAL CODE SECTION 401(A)(9) "MINIMUM DISTRIBUTION" REGULATIONS.**

- i. During plan participant's life, the actual beneficiary designation is irrelevant to determine required minimum distribution
- ii. Uniform Lifetime Table used (based on the joint life expectancy of the plan participant and a person 10 years younger). In most cases, this results in a substantially longer deferral period than prior law;
 - (1) If the participant's spouse is the sole beneficiary, the distribution is based on actual life expectancy of the participant and the spouse;
 - (2) Life expectancy tables under Regulation Section 1.401(a)(9)-9.
- iii. The existence and identity of the Designated Beneficiary is determined as of September 30th of the year following the year of the participant's death (Regulation Section 1.401(a)(9)-4);

b. **PARTICIPANT DIES BEFORE THE REQUIRED BEGINNING DATE "RBD"** - which is generally the later of the April 1st after age 70 ½ or retirement, the plan is distributed over the Designated Beneficiary's life expectancy (spouses can recalculate their life expectancy AND/OR defer payment until participant's RMD OR rollover account to their own IRA, thereby resulting in longer payouts). If there is no Designated Beneficiary, the entire plan must generally be distributed in five years. (Regulation Section 1.401(a)(9)-5);

c. **PARTICIPANT DIES AFTER THE REQUIRED BEGINNING DATE**, under Regulation Section 1.401(a)(9)-5, the plan is distributed over the longer of:

- i. the Designated Beneficiary's life expectancy (spouses can recalculate their life expectancy OR rollover account to their own IRA, resulting in longer payouts);
- ii. the participant's actuarial remaining life expectancy (if there is no Designated Beneficiary, plan assets are distributed over the plan participant's remaining life expectancy (above 5-year rule inapplicable));

d. **MULTIPLE BENEFICIARIES** (Regulation Section 1.401(a)(9)-5 (A-7)(a)):

- i. General Rule: the designated beneficiary with the shortest life expectancy will be used in determining Required Minimum Distributions;
- ii. Exceptions:

- (1) Separate Account Rule - if the participant's benefit under a plan is divided into separate accounts payable to different beneficiaries, each account is not aggregated with the others for calculating required minimum distributions. Instead, "the rules of sections 401(a)(9) separately apply to such separate account". (See Regulation Section 1.401(a)(9)-8);
 - (2) Example Separate Account Rule:
IRA beneficiary designation names three Children (Ages 25, 35 and 45) as equal beneficiaries.
 - (a) Result: Under the separate share rule each child can calculate his Required Minimum Distribution on his own life expectancy (rather than based on the life expectancy of the oldest of the multiple beneficiaries);
 - (b) Thus, the younger children [ages 25 and 35] are not saddled with the shorter life expectancy (equals greater required minimum distributions) of their eldest [age 45] sibling.
 - iii. Separate Share Rule Not Applicable to Trusts (See Regulation Section 1.401(a)(9)-4 A-5(c) [discussed below];
 - iv. "Cash Out" Rule (discussed below)
- e. **RISK OF LIVING TRUST HAVING NO "DESIGNATED BENEFICIARY"**
- i. General Rule: ALL trust beneficiaries must be individuals; if a trust has individuals and non-individuals designated as beneficiaries, then there can be no designated beneficiary (Regulations Section 1.401(a)(9)-4, A-1 and A-3)
 - ii. Significance of no Designated Beneficiary;
 - (1) If participant dies before RBD, distribution within 5 years;
 - (2) If participant dies after RBD, distribution over participant's remaining life expectancy,
- f. **COMMON LIVING TRUST "PROBLEM" PROVISIONS:**
- i. **\$100,000.00 Gift to Charity at Death;**
 - (a) Possible Result: IRA has no Designated Beneficiary because the charity is not a permissible (i.e., individual) beneficiary.
 - ii. **Living Trust Has Primary Responsibility to Pay the Grantor's Debts and Expenses of Administering Trust Property and/or Probate Estate**
 - (a) Possible Result: IRA has no Designated Beneficiary because creditors and/or the probate estate are not permissible (i.e., non-individual) beneficiaries.

- iii. **\$50,000.00 to Grantor's mother**
 - (a) Possible Result: Mom is the oldest of all trust beneficiaries, so mom's life expectancy is used in calculating Required Minimum Distributions
- iv. **Living Trust is Designated Beneficiary, which provides for Outright Distribution in Equal Shares to Three Children Ages 25, 35 and 45.**
 - (a) Possible Inequitable Result: Child Age 45 is the oldest of all trust beneficiaries, so such oldest child's life expectancy (38,8 years) is used in calculating Required Minimum Distributions for all three children (even though, the 25 year-old has an actual 58.2 year life expectancy)

g. **"SOLUTIONS" TO ABOVE PROBLEMS:**

- i. Drafting solutions (Problem (2) - payment of debts and expenses)
 - (1) **Living trust contains a boilerplate provisions** which says the IRA assets may not be used to pay charities, administrative obligations, or gifts to older beneficiaries

Examples:

... (in debt payment clause) the trustee shall not make payment from any individual account in an employee benefit plan, individual retirement plan, or IRA owned by me.

...(in debt payment clause) in making the payments required under this Article and in making any charitable gifts under this instrument after my death, the trustee, to the extent possible, shall not use any benefits payable to the trust under any qualified retirement plan, individual retirement account or other retirement arrangement subject to the "minimum distribution rules" of IRC Section 401(a)(9) or any successor provisions.
(excerpt from the Harris Bank formbook).

...further, the trustee shall not use any such retirement benefits to pay amounts to any beneficiary ten years older than Grantor.

- (2) Trust provisions should make the **client's probate estate (even if probate is not contemplated) have primary responsibility for paying administrative expenses** (problem (2) above).

Example (from Northern Trust Company formbook)

(Trust provision - Form 201)

SECOND: Upon my death, if I have no probate estate, or to the

extent that the cash and readily marketable assets in the principal of the residue of my probate estate are insufficient, the trustee shall make the following payments from the principal of the trust estate. The trustee shall pay the expenses of my last illness and funeral, costs of administration including ancillary, costs of safeguarding and delivering legacies... (Northern Trust Formbook, Form 201 - Living Trust form)

(Will provision - Form 109)

FIRST: My executor shall pay all expenses of my last illness and funeral, costs of administration including ancillary, costs of safeguarding and delivering legacies, and other proper charges against my estate...If, however, cash and readily marketable assets in the principal of the residue of my estate are insufficient to make the foregoing payments in full, my executor shall certify the amount of the insufficiency to the then acting trustee under the trust agreement hereafter mentioned for payment.

ii. **The “Cash-Out” Solution** (Problems (1) and (3) - charitable gift and gift to Mom)

- (a) Since the Designated Beneficiary is determined as of September 30 of the year following the participant’s death, paying off the non-individual beneficiaries by such date removes such beneficiaries from being considered in determining a possible Designated Beneficiary
- (b) Thus, in the above examples, if the trustee satisfies the gifts to the charity and mother by September 30th of the year following the participant’s death, the charity and mother are not taken into account in determining the “Designated Beneficiary”

iii. **Beneficiary Designation Solution to Trust “Separate Share Issue** (Problems (4) - trust is beneficiary, with outright distribution to children ages 25, 35 and 45).

- (a) Place the division of the IRA into the beneficiary designation form rather than the trust:

Sample IRA Beneficiary Designation #1 obtaining Separate Share Treatment:

To my children who survive me, in equal shares, except that the then living descendants of a deceased child of mine shall take per stirpes the share which the child would have received if living, and except further that if my revocable trust agreement or will creates a trust for a child or descendant of mine, his or her share of the account shall be allocated to that trust.

Sample IRA Beneficiary Designation #2 obtaining Separate Share Treatment:

(excerpt) **KARI SMITH**, if she is then living, except that if she has not attained age 25, or is not living, such share shall be distributed to the then acting trustee of The John Smith Declaration of Trust dated November 21, 2003, to be added to the share created for such grandchild and her descendants, or if none, as otherwise provided in such trust agreement.

iv. **The Disclaimer Solution** (other scenarios)

- (a) Similar to the Cash-Out, but rather the objectionable beneficiary disclaims the retirement interest so it passes to a beneficiary more amenable under the required minimum distribution rules

v. **The “Conduit Trust” Solution** (other scenarios)

- (1) If Trust provisions requires the trustee to **distribute all amounts (income and Required Minimum Distributions) received from a retirement plan to the current beneficiary**, then the contingent or remainder beneficiaries are not considered beneficiaries of the trust for purposes of determining a potential designated beneficiary. (Regulations Section 1.401(a)(9)-5 (A-7)(c)(3) Example 2);

- (2) **Conduit Trust for Surviving Spouse** enables spouse to recalculate life expectancy, thereby resulting in greater income tax deferral;

(a) **Example #1 - "Conduit Trust" Inapplicable for Spouse:**

\$1 million QTIP trust is established at Dad’s (age 76) death in 2003 for the benefit of Mom (age 75), with remainder to children. The trust provides that income be paid directly to Mom upon receipt by the trustee of the QTIP trust.

Result: Mom and her children are the Designated Beneficiaries, even though the children must wait until Mom’s death to inherit the IRA (theory: amounts exceeding income payable from the IRA to the trust may be accumulated for the benefit of the children).

Since Mom is the beneficiary with the shortest life expectancy, her life expectancy is used determined in the year following death and reduced by one for each passing year (no recalculation of life expectancy). Thus, the IRA can be distributed in annual installments over 12.7 years (single life expectancy of Mom under regulations), as follows:

| | |
|-------------------------------|-------------|
| 2004 - (12.7 life expectancy) | 12.7 (7.9%) |
| 2005 - (above expectancy -1) | 11.7 (8.6%) |
| 2006 - (above expectancy -1) | 10.7 (9.3%) |
| 2007 - (above expectancy -1) | 9.7 (10.3%) |

| | | |
|------------------------------|-----|---------|
| 2008 - (above expectancy -1) | 8.7 | (11.5%) |
| 2009 - (above expectancy -1) | 7.7 | (13%) |
| 2010 - (above expectancy -1) | 6.7 | (15%) |
| 2011 - (above expectancy -1) | 5.7 | (17.5%) |
| 2012 - (above expectancy -1) | 4.7 | (21.3%) |
| 2013 - (above expectancy -1) | 3.7 | (27%) |
| 2014 - (above expectancy -1) | 2.7 | (37%) |
| 2015 - (above expectancy -1) | 1.7 | (58.8%) |
| 2016 - (above expectancy -1) | .7 | (70%) |
| 2017 - (above expectancy -1) | 0 | (100%) |

(b) **Example #2 - "Conduit Trust" Treatment for Spouse/Greater Income Tax Deferral**

\$1 million QTIP trust is established at Dad's (age 76) death in 2003 for the benefit of Mom (age 75), with remainder to children. The trust provides that the greater of income or Required Minimum Distributions be paid directly to Mom upon receipt by the trustee of the QTIP trust.

Conclusion: Mom is the sole Designated Beneficiary. Required Minimum Distributions must begin the year after death based on Mom's recalculated life expectancy (presume Mom lives at least to 2017; after Mom's death, the distributions would be based on her remaining life expectancy at death, reduced by one for each passing year):

| | | |
|-----------------------------------|------|---------|
| 2004 - factor (based on age 76) = | 12.7 | (7.9%) |
| 2005 - factor (based on age 77) = | 12.1 | (8.3%) |
| 2006 - factor (based on age 78) = | 11.4 | (8.8%) |
| 2007 - factor (based on age 79) = | 10.8 | (9.3%) |
| 2008 - factor (based on age 80) = | 10.2 | (9.8%) |
| 2009 - factor (based on age 81) = | 9.7 | (10.3%) |
| 2010 - factor (based on age 82) = | 9.1 | (11%) |
| 2011 - factor (based on age 83) = | 8.6 | (11.7%) |
| 2012 - factor (based on age 84) = | 8.1 | (12.4%) |
| 2013 - factor (based on age 85) = | 7.6 | (13.2%) |
| 2014 - factor (based on age 86) = | 7.1 | (14.1%) |
| 2015 - factor (based on age 87) = | 6.7 | (15%) |
| 2016 - factor (based on age 88) = | 6.3 | (15.9%) |
| 2017 - factor (based on age 89) = | 5.9 | (17%) |

(3) **Sample "Conduit Trust" Language for QTIP Marital Trust**

"...In addition, all other distributions and withdrawals from the individual account to the Marital Trust shall be paid to my wife upon receipt by the trustee of the Marital Trust."

h. **NORTHERN TRUST COMPANY: BENEFICIARY DESIGNATION TABLE**¹:

I. Married Client

A. **First Spouse**

1. Client does not need to use IRA to fund the credit shelter Bypass Trust.

Beneficiary: Client's spouse, outright. This beneficiary designation provides the most flexibility for tax purposes.

2. Client has to use IRA to fund the Bypass Trust in part or in whole.

Beneficiary:

- a. Disclaimer approach. Primary beneficiary is client's spouse, outright. If spouse disclaims, the beneficiary of the disclaimed part of the IRA is: The Bypass Trust created under client's revocable trust or will. Spouse disclaims just enough of the IRA to fund the Bypass Trust fully.
- b. The client's revocable trust, or the trust created under client's will. The trust contains a fractional share formula and establishes a Bypass Trust and an outright marital share.

B. **Second Spouse, and Children by First Marriage**

1. Client does not need to use IRA to fund the Bypass Trust.

Beneficiary: The QTIP trust created under client's revocable trust or will.

2. Client has to use IRA to fund the Bypass Trust in part or in whole.

Beneficiary: The client's revocable trust, or the trust created under client's will. The trust contains a fractional share formula and establishes a Bypass Trust and a QTIP marital trust.

¹ The forgoing is an excellent Beneficiary Designation table developed principally by David B. Hirschey, Senior Attorney of the Northern Trust Company. Permission granted author to use these materials by Mr. Hirschey.

II. Unmarried Client

A. All children receive their inheritances outright.

Beneficiary: Client's children who survive her, in equal shares, except that the then living descendants of a deceased child shall take by representation the share which the child would have received if living.

B. One or more children receive their inheritances in trust.

Beneficiary: Client's children who survive her, in equal shares, except that the then living descendants of a deceased child shall take by representation the share which the child would have received if living, and except further that if client's revocable trust agreement or will creates a trust for a child or descendant, his or her share of the IRA shall be allocated to that trust.

The beneficiary designation (or the IRA agreement) should clearly provide that:

Beneficiary/owner may withdraw any part or all of his or her share of the IRA at any time or times. Ownership of IRA is vested in beneficiary at death of client.

If a trust is the beneficiary of the IRA, consider using one of the following traditional techniques:

1. (a) The trust should not contain a gift to a charity. (b) The trust should not have primary responsibility for paying the decedent's administration expenses, debts, death taxes, or other obligations of the decedent's probate estate. Rather, the trust should have only secondary responsibility, or no responsibility at all, for paying those items. The will should give the probate estate primary responsibility for paying those items, even if the client hopes to avoid probate at death. (c) The spouse should be the oldest of all of the beneficiaries of the trust (including both present and future beneficiaries).
2. The trust instrument contains a boilerplate provision which states that upon and after the death of the client, the trustee of the trust may not use an IRA to satisfy any charitable gift, to pay the obligations of the IRA owner's probate estate, or to benefit any trust beneficiary who is older than the spouse.

The goal is to ensure that the IRA will have a "designated beneficiary" for purposes of the minimum distribution rules. Under the 2002 minimum distribution rule regulations, another possible, less cumbersome approach to attaining this goal might be to rely on the "cash out" technique in finalized Treas. Reg. §1.401(a)(9)-4(A-4)(a). [E.g., the revocable trust contains a gift to charity, but the trustee satisfies the charitable gift in full before September 30 of the year following the year of client's death, so the charity is "cashed out" and is not considered as a beneficiary of the trust for minimum distribution rule purposes on the September 30 date.]