By **Bruce D. Steiner**

Decanting Trusts to Remove Unwanted Beneficiaries

Keep assets in the individual retirement account for as long as possible

It's generally beneficial to keep assets in individual retirement accounts for as long as possible because IRAs provide significant tax benefits. But, if IRA benefits are payable to a trust, and all of the beneficiaries and permissible appointees of the trust are individuals, the one with the shortest life expectancy (that is, the oldest one) is the designated beneficiary for purposes of determining the applicable distribution period (that is, the required distributions).[1] This will end up depleting assets from the IRA sooner. To avoid this result, it pays to remove unwanted beneficiaries from the trust. There are several ways to do this, including decanting the trust.

Benefits of IRAs

Qualified plans and IRAs provide significant income tax benefits. The income and gains in a Roth IRA and distributions from a Roth IRA are generally tax free. In the case of a traditional IRA, contributions are generally tax deductible, and the income and gains within the IRA generally aren't taxable until distributions are made.

Required Distributions

There are limits on how long assets may be kept in an IRA. In the case of a traditional IRA, the IRA owner must begin taking distributions on reaching his required beginning date (RBD) (generally April 1 of the year after he reaches age 70½).[2] The IRA owner must then generally take distributions over the joint life expectancy of himself and a hypothetical individual 10 years younger, recalculated annually.[3] In the case of a Roth IRA, there are no required distributions during the IRA owner's lifetime.[4]

Following the IRA owner's death, a nonspouse designated beneficiary must take distributions over his life expectancy.[5] A spouse beneficiary may roll the IRA benefits over into his own IRA, name new beneficiaries and, in the case of a traditional IRA, defer distributions until his RBD. By naming young beneficiaries, the IRA can continue to grow for many years after the IRA owner's death, providing substantial income tax benefits.

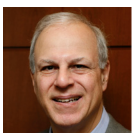
When IRA benefits are payable to a trust, a remainder or contingent beneficiary is considered a beneficiary.[6] Thus, for example, when retirement benefits were payable to a trust for a child who couldn't exercise her power of appointment (POA) in favor of anyone older than the oldest child and the trustees couldn't make distributions to another trust in which anyone older than the oldest child could be a beneficiary or a permissible appointee, the oldest child was treated as the oldest beneficiary of the trust.[7]

It doesn't matter how remote the contingency is. For example, in PLR 200228025 (July 12, 2002), an IRA owner left her IRA to separate trusts for the benefit of her two minor grandchildren, but if both grandchildren died before age 30, the balance of the trust was payable to contingent beneficiaries, the oldest of whom was age 67. Even though the 67-year-old's interest was remote, the Internal Revenue Service considered her to be a beneficiary.

Conduit Trusts

There's an exception for a "mere potential successor beneficiary."

For example, if all of the distributions during B's lifetime are payable to B, none of the amounts



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distributed during B's lifetime may be accumulated in the trust, and the remainder at B's death is payable to other beneficiaries, the other beneficiaries are mere potential successors to B and are disregarded in determining the required distributions.[8]

Such a trust is commonly referred to as a "conduit trust." However, conduit trusts suffer from several disadvantages. In the above example, if B lives to life expectancy, nothing will be left in the IRA or the trust. All of the IRA benefits will have been distributed to B, will be included in B's estate and will be subject to B's creditors, spouses and Medicaid. If the trustees had discretion to accumulate some or all of the distributions, the trust wouldn't be a conduit trust, so that the remainder and subsequent beneficiaries would be considered in determining the oldest beneficiary. However, the IRA benefits could be accumulated in the trust and thus could be kept out of B's estate and protected against B's creditors, spouses and Medicaid.

Because the recipient trust may be for the benefit of some, but not all, of the beneficiaries of the existing trust, decanting provides a way to eliminate older beneficiaries.

The identity of the beneficiaries of a trust is determined as of Sept. 30 following the year of the IRA owner's death.[9] This provides a window in which to eliminate unwanted beneficiaries who are older than the oldest desired beneficiary, as well as beneficiaries other than individuals or trusts subject to the same restrictions.

Disclaimer

The simplest way to remove unwanted beneficiaries is for the older beneficiaries to disclaim their interests in the trust. If a beneficiary makes a qualified disclaimer within nine months from the IRA owner's death, the disclaimant won't be counted as a beneficiary of the trust for purposes of determining the oldest beneficiary of the trust.[10] Thus, for example, if the 67-year-old contingent beneficiary in PLR 200228025 had disclaimed her interest in the trust, she wouldn't have been considered a beneficiary of the trust.

However, it's not always possible to eliminate all of the unwanted beneficiaries by disclaimer. For example, a beneficiary might have a broad POA, and it might not be practical for all of the permissible appointees to disclaim. Or, if a charity is a remainder beneficiary, the charity might not disclaim.

In this regard, for a disclaimer to be qualified, the disclaimant may not direct how the disclaimed property will pass. In addition, except in the case of a spouse, the disclaimed property must pass to persons other than the disclaimant.[11]

The disclaimant must be careful to disclaim any benefits he may receive as a result of the disclaimer. For example, in PLR 200846003 (Nov. 14, 2008), the IRA was payable to the children. The children disclaimed the IRA, so it was payable to the IRA owner's estate. Under the terms of the IRA owner's will, the IRA was payable to a trust for the benefit of the IRA owner's spouse, with remainder to the children. Because the children retained an interest in the disclaimed IRA as remainder beneficiaries of the trust, their disclaimers weren't qualified and hence were taxable gifts. For the disclaimers to have been qualified disclaimers, the children had to disclaim their interests in the IRA through the estate and the trust.

From an income tax standpoint, the result in PLR 200846003 wasn't a good one. If the children hadn't disclaimed, the IRA would be payable over the children's life expectancies. By disclaiming in favor of a trust for the spouse, the distribution period was limited to the spouse's life expectancy. If the IRA owner had named the spouse as the beneficiary, the spouse could have rolled the IRA over into her own IRA, named new beneficiaries, possibly converted to a Roth IRA and obtained a longer stretch. With enough disclaimers, it may have been possible to get the IRA to the spouse who could then have rolled it over into her own IRA.[12]

Partially Release a POA

Another way to eliminate unwanted beneficiaries is to partially release a POA. For example, in PLR 201203003 (Jan. 20, 2012), the IRA owner's son

had a general testamentary POA over a trust, which he could exercise in favor of anyone. He partially released his POA so that he could only exercise it in favor of individuals who weren't older than the surviving spouse. The IRS ruled that the surviving spouse would be treated as the designated beneficiary, so that the IRA benefits could be stretched over the surviving spouse's lifetime. Of course, from an income tax standpoint, it would be better if the IRA had been payable to the spouse or in part to the spouse and in part to or in trust for the son, with the class of permissible appointees being limited to individuals who weren't older than the son or who weren't older than the older of the son and his spouse.

The IRS again approved a partial release of a POA in PLR 201840007 (Oct. 5, 2018). This still allowed for a broad class of permissible appointees. The IRS had also approved a similar broad class of permissible appointees in PLR 200235038 (April 10, 2015).[13]

Decanting

It may not always be possible to eliminate unwanted beneficiaries by a disclaimer or a partial release of POAs. In these cases, another way to eliminate unwanted (older) beneficiaries may be to decant the trust.

Decanting a trust means distributing the trust assets to another trust for some or all of the beneficiaries of the existing trust. In this context, the new trust wouldn't include the unwanted beneficiaries.

There are three bases for decanting a trust: (1) pursuant to a state decanting statute, (2) pursuant to authority under the will or trust agreement, and (3) under common law.

More than half of the states have decanting statutes. In each case, if the trustees have complete discretion to distribute the principal of the trust to one or more beneficiaries outright, they may distribute some or all of the trust assets to another trust for the benefit of some or all of the beneficiaries of the existing trust. For example, if the remainder of a marital or credit shelter trust is payable to the children on the spouse's death, but the trustees have complete discretion to distribute the principal of the trust to the spouse, the trustees may decant the trust assets into a new trust in which the spouse has a POA or in which the remainder passes to the children in further trust rather than outright. The theory behind this is that, because the trustees could have distributed the principal to the spouse outright, the children have no entitlement to anything.

Because the recipient trust may be for the benefit of some, but not all, of the beneficiaries of the existing trust, decanting provides a way to eliminate older beneficiaries. While decanting is a fiduciary decision, the interest of an older contingent beneficiary or charity may be sufficiently remote that a trustee may determine that the benefit of the longer stretch outweighs the loss to the older beneficiaries/y or charity of their interests, especially if their interests are remote.

> It's often simpler to decant pursuant to a provision in the will or trust instrument than to follow the statutory procedure.

Many state decanting statutes also permit decanting when the trustees have limited discretion to distribute principal, such as for an ascertainable standard. Under most of these statutes, distributions from the recipient trust must be limited to the same standard.

The will or trust instrument may also authorize the trustees to decant a trust. Such a provision is useful in case a testator moves to a state that doesn't have a decanting statute. It's also often simpler to decant pursuant to a provision in the will or trust instrument than to follow the statutory procedure. For these reasons, it's generally advisable to include the authorization to decant in a will or trust instrument.

PLR 200537004 (Sept. 16, 2005) illustrates decanting under a provision in a will or trust agreement. In that PLR, the IRA was payable to a conduit trust. However, the trust agreement specifically authorized a trustee (called a "protector" though functioning as a trustee) to decant (called a "disclaimer" but in effect a decanting) the trust into a discretionary (accumulation) trust.[14]

While the common law is sparse, it appears to

provide that a trustee who has complete discretion to distribute principal may decant the trust into another trust for the benefit of one or more of the beneficiaries of the existing trust.[15]

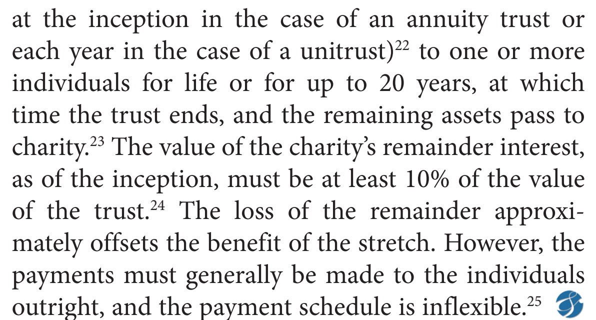
An advantage of decanting to eliminate unwanted beneficiaries is that when decanting is available, the trustees may decant without involving the beneficiaries. By contrast, a disclaimer requires the involvement of the disclaimant, and a partial release of a POA requires the involvement of the holder of the POA.

At one time, the IRS allowed the reformation of a trust to eliminate unwanted beneficiaries.[16] However, since 2010, the IRS has refused to allow the elimination of unwanted beneficiaries by reformation.[17] Nevertheless, reformation continues to be available in other contexts. For example, in *Matter of Sukenik*, the decedent left his IRA to his wife and other assets to the couple's charitable foundation. The appellate court reformed the IRA owner's will and beneficiary designation so that the IRA would go to the foundation charity and other assets of equal value would go to the surviving spouse.[18] However, because it wasn't from the state's highest court, the IRS isn't bound by the appellate court's decision in *Sukenik*.[19] If the IRS were to treat the reformation as a sale of the IRA by the wife to the charity, the wife might be taxed on the value of the IRA. That would be worse than if she'd taken the IRA and rolled it over into her own IRA.

Pending Legislation

IRA owners and trustees should also keep in mind the pending legislation that would limit the stretch to 10 years for most nonspouse beneficiaries.[20] This would substantially reduce the benefit of the stretch, but would eliminate the need to exclude older persons as beneficiaries and permissible appointees of trusts. If this legislation is enacted, it will be possible to replicate the stretch by naming a charitable remainder trust (CRT) as the beneficiary of the retirement benefits. This was often done by IRA owners who had elected recalculation and didn't have a spouse beneficiary before the proposed regulations were overhauled in 2001.

A CRT is tax exempt,[21] so it may take the entire IRA at once without accelerating the income tax. The CRT then distributes a percentage (at least 5%) of the value of the trust assets each year (determined either at the inception in the case of an annuity trust or each year in the case of a unitrust)[22] to one or more individuals for life or for up to 20 years, at which time the trust ends, and the remaining assets pass to charity.[23] The value of the charity's remainder interest, as of the inception, must be at least 10% of the value of the trust.[24] The loss of the remainder approximately offsets the benefit of the stretch. However, the payments must generally be made to the individuals outright, and the payment schedule is inflexible.[25]



Endnotes

1. Treasury Regulations Section 1.401(a)(9).
2. Internal Revenue Code Sections 401(a)(9)(A), 401(a)(9)(C) and 408(a)(6).
3. IRC Section 401(a)(9)(G); Treas. Regs. Section 1.401(a)(9)-5.
4. Section 408A(c)(5).
5. Treas. Regs. Section 1.401(a)(9)-5 A-4(c)(1).
6. Treas. Regs. Section 1.401(a)(9)-5 A-7(b).
7. Private Letter Rulings 200235038 (Aug. 30, 2002) through 200235041 (Aug. 30, 2002).
8. Treas. Regs. Section 1.401(a)(9)-7 A-7(c)(3) Example 2.
9. Treas. Regs. Section 1.401(a)(9)-4 A-4(a) and A-5(a).
10. Treas. Regs. Section 1.401(a)(9)-4 A-4(c); *see* IRC Section 2518.
11. Section 2518(b)(4); Treas. Regs. Section 25.2518-2(3).
12. Bruce D. Steiner, "IRA Rollovers," *Trusts & Estates* (June 2015); Bruce D. Steiner, "Postmortem Strategies to Shift Retirement Benefits to the Spouse," 24 *Estate Planning* 369 (October 1997).
13. Bruce D. Steiner, "Post-Mortem Action Can Limit Class of Beneficiaries," *Trusts & Estates* (May 2012).
14. If the trust in PLR 200537004 (Sept. 16, 2005) had been a discretionary (accumulation) trust from the inception, the trustees could have distributed the amount received from the individual retirement account if they determined that it would be advisable to do so.
15. *Matter of Spencer*, 232 N.W.2d 491 (Iowa 1975); *Phipps v. Palm Beach Trust Co.*, 186 Fla. 782 (1940); *see Morse v. Kraft*, 466 Mass. 92 (2013).
16. PLRs 200620026 (May 19, 2006) and 200235038 (Aug. 30, 2002) through 200235041 (Aug. 30, 2002).
17. PLRs 201628004 (July 8, 2016) and 201021038 (May 28, 2010).
18. *Matter of Sukenik*, 2018 NY Slip Op. 4658 (1st Dept. 2018), *rev'g* 2016 NY Slip Op. 31217 (Surr. Ct. N.Y. Co. 2016, File No. 2014-201A).
19. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).
20. H.R.____ (116th Cong., 1st Sess. 2019).
21. IRC Section 664(c)(1).
22. Sections 664(d)(1) and 664(d)(2).
23. Sections 664(d)(1)(A) and 664(d)(2)(A).
24. Sections 664(d)(1)(D) and 664 (d)(2)(D).
25. *See supra* note 23.