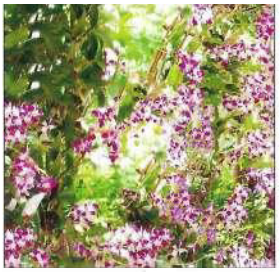

Drafting Multi-Generation Trusts under the SECURE Act Proposed Regulations

Discussing additional planning options available under the Proposed Regulations.

JAMES G. BLASE

The purpose of this article is to examine how well perpetual or multi-generation trusts fit with the SECURE Act Proposed Regulations issued last year,[1] and to explore various drafting opportunities in light of the release of the same.

A Typical Multi-Generation Trust Example.

In an effort to examine how well a typical multi-generation trust operates under the Proposed Regulations, let's examine a typical multi-generation trust used in estate planning. (For purposes of this article examples do not involve an "eligible designated beneficiary trust" under the SECURE Act.) Normally if the clients have two or more children, a separate trust is established for each child and the child's own descendants, with the remainder as each trust passes held in separate trusts for the child's own children and their respective descendants, etc. If a child and all of his descendants should die out, the remaining trust assets pour over into the trusts for the benefit of the clients' other children and their descendants, etc. (the remainder trusts). If all of the client's descendants should die out, the remaining assets of the "survivor" trust then typically pass to one or more other individual beneficiaries and/or to charity. Lastly, each child or remote descendant will typically have been given a combination of limited and/or general testamentary powers of appointment over the assets remaining in his trust at the time of his death.

JAMES G. BLASE, CPA, JD, LLM is a 40-year experienced estate planning attorney practicing in St. Louis, Missouri. He has published three books and over 75 articles on various estate planning topics, including for *Estate Planning*, and multiple other works on subjects from Theodore Roosevelt to St. Jacinta of Fatima. A frequent presenter at various tax and estate planning symposiums, Jim has also served as adjunct professor in the Villanova University School of Law Graduate Tax Program and at the St. Louis University School of Law. He is a graduate of the Notre Dame Law School and the New York University Graduate Program in Taxation. *DISCLAIMER: This article went to press before any final regulations construing the SECURE Act were promulgated by the Internal Revenue Service and should therefore be read with this disclaimer in mind.*

Now examine how well this typical perpetual or multi-generation fact pattern fits with the SECURE Act proposed regulations, having primarily in mind the goal of achieving the maximum available 10 years in deferral for the post-death required payout of the clients' remaining IRA and/or 401k accounts.

Relevant Proposed Regulation Provisions. Set forth below are the relevant provisions of the Proposed Regulations.

Proposed Regulation 1.401(a)(9)-4(f)(3)(i) provides:

> Subject to the rules of paragraph (f)(3)(ii) and (iii) of this section, the following beneficiaries of a see-through trust are treated as having been designated as beneficiaries of the employee under the plan–
>
> (A) Any beneficiary who could receive amounts in the trust representing the employee's interest in the plan that are neither contingent upon, nor delayed until, the death of another trust beneficiary who did not predecease (and is not treated as having predeceased) the employee, and

> (B) Any beneficiary of an accumulation trust that could receive amounts in the trust representing the employee's interest in the plan that were not distributed to the beneficiaries described in paragraph (f)(3)(i)(A) of this section.

These two paragraphs A and B of the Proposed Regulation 1.401(a)(9)-4(f)(3)(i) rules are expressly made subject to subparagraphs (ii) and (iii). Subparagraph (iii) relates to conduit trusts, which typically are not employed in a multi-generation trust situation, so this subparagraph need not be addressed here. Subparagraph (ii), on the other hand, relates to accumulation trusts. It provides:

> Any beneficiary of an accumulation trust who could receive amounts from the trust that represent the employee's interest in the plan solely because of the death of another beneficiary described in paragraph (f)(3)(i)(B) of this section [unless the beneficiary is also described in paragraph (f)(3)(i)(A)] is not treated as having been designated as a beneficiary of the employee under the plan. [Bracketed language inserted to avoid the need to read cross-reference separately.]

This sentence from the preamble to the Proposed Regulations summarizes the Internal Revenue Service's specific intention in including the just-quoted subparagraphs (i) and (ii): "These proposed regulations also provide for certain beneficiaries of a see-through trust to be disregarded as beneficiaries of the employee for purposes of section 401(a)(9), because they have only minimal or remote interests." This preamble passage will become important in construing the breadth of the following two sections of the Proposed Regulations relevant to perpetual or multi-generation trusts.

Proposed Regulation 1.401(a)(9)-4(f)(4) provides:

> If a beneficiary of a see-through trust is another trust, the beneficiaries of the second trust will be treated as beneficiaries of the first trust, provided that the requirements of paragraph (f)(2) of this section [relating to the standard trust requirements for designated beneficiary trusts] are satisfied with respect to the second trust. In that case the beneficiaries of the second trust *are treated as having been designated as beneficiaries of the employee under the plan.* [Bracketed material and emphasis supplied.]

Proposed Regulation 1.401(a)(9)-4(f)(5)(ii)(A) provides, in relevant part, that if a

> power of appointment is not exercised (or restricted) in favor of one or more beneficiaries that are identifiable within the meaning of paragraph (f)(5)(i) of this section, then each taker in default (that is, any person that is entitled to the portion that represents the employee's interest in the plan subject to the power of appointment in the absence of the powerholder exercising the power) *is treated as a beneficiary designated under the plan.* [Emphasis supplied.]

Placed in the context of a perpetual or multi-generation trust, these two sections of the Proposed Regulations provide that when a remainder beneficiary under a trust is a second trust, "the beneficiaries of the second trust are treated as having been designated as beneficiaries of the employee under the plan," and that when the second trust is a taker in default of a testamentary power of appointment, the second trust "is treated as a beneficiary designated under the plan," and by extension under Proposed Regulation 1.401(a)(9)-4(f)(3)(i), certain of its beneficiaries "are treated as having been designated as beneficiaries of the employee under the plan." Based on the specific terms of the second trust, the next step is to determine which of the two categories of "designated as beneficiaries of the employee under the plan" addressed in Section 1.401(a)(9)-4(f)(3)(i) set out above - the "Paragraph A" category and/or the "Paragraph B" category - do the beneficiaries of the second trust fall. If they all fall into the Paragraph B category, *exclusively*, then Proposed Regulation 1.401(a)(9)-4(f)(3)(ii) provides that if one of the Paragraph B beneficiaries takes solely as a result of the death of another Paragraph B beneficiary, the former Paragraph B beneficiary is "not treated as having been designated as a beneficiary of the employee under the plan."

An option which is available under the Proposed Regulations, but arguably not prior to the issuance of the same, is to provide in the client's trust document that, in the case of any trust beneficiary who at the time is the last descendant of the client then standing, it is the client's desire that said beneficiary designate X Charity as appointee under a testamentary power of appointment in the beneficiary, at least to the extent a surviving spouse or any other desirable appointee is not designated.

In the example outlined above, all of the beneficiaries of the trusts for the benefit of the clients' other children and their descendants fall *exclusively* into the Paragraph B category. This is because none of them has any current interest in the first trust. Thus, if one these Paragraph B beneficiaries of the

[1] 87 FR 10504. Compare the discussion at Choate, "Estate Planning for Retirement Benefits 2023" (February 27, 2023), at page 57, available at www.ataxplan.com

other trusts [e.g., the contingent remainder beneficiary, in the above example] can take solely as a result of the death of another Paragraph B beneficiary of the other trusts, Proposed Regulations 1.401(a)(9)-4(f)(3)(i) and (ii) direct that the former [contingent remainder] beneficiary is not treated as having been designated as a beneficiary of the employee under the plan, and therefore can be disregarded for purposes of determining the beneficiary designated by the employee under the plan.

This conclusion is consistent with still another sentence from the preamble to the Proposed Regulations: "[A] see-through trust beneficiary is not treated as a beneficiary of the employee if that beneficiary could receive payments from the trust that represent the employee's interest in the plan only after the death of another trust beneficiary whose sole interest is a residual interest in the trust and who did not predecease (and is not treated as having predeceased) the employee."

Multi-Generation Trust Drafting

Charity as Contingent Taker. What does the above discussion mean for multi-generation trust drafting? One would think that, in most circumstances, ensuring that charity is designated as the contingent taker in the case of a multi-generation trust would probably be low on the priority table of most clients establishing these types of trusts, i.e., because of the low probability the contingent gift will ever become effective. If the client nevertheless wants to ensure that charity would take under the contingent gift clause, but also wants to defer income tax on his IRAs, etc. for as long as possible, and with the greatest flexibility possible regarding how much of the IRAs, etc. must be withdrawn each year, the client would have the following options, depending upon whether they are already beyond their required beginning date, and depending upon whether the drafting attorney agrees with the above analysis regarding why the charity's contingent interests should be disregarded in determining the designated beneficiary of the trust:

1. Assuming the client is already beyond their required beginning date, and the drafting attorney does not agree with the above analysis disregarding charitable contingent takers from the trust designated beneficiary determination, the client and attorney may simply allow the trusts to be treated as disqualified (i.e., because charity is not a permissible beneficiary), and allow the IRAs, etc. to be paid out over the client's remaining life expectancy. As long as the client is age 82 or younger, this period will be 10 years or longer. If the client is older than age 82, however, this option may prove to be undesirable. Life expectancy drops to five years at age 92.

2. If the client is already beyond their required beginning date and chooses not to proceed under option 1, their two options would be to either (a) rely on the analysis outlined above as to why 10-year deferral applies, with annual payments during the 10-year term based on the oldest, not disregarded, designated beneficiary of the trust's life expectancy, or (b) draft the trust instrument so that IRAs, etc. are held in a separate trust from the client's other assets, not allowing the "IRA trust" to pass to charity, and with a potential adjustment in the "non-IRA trust" for the elimination of the charity's share of the IRA trust.[2]

3. If the client has not reached their required beginning date their two options if they do not want the default 5-year rule to apply would be to either (a) rely on the analysis outlined above as to why 10-year deferral applies, with no annual payments required during the 10-year term, or (b) draft the trust instrument so that IRAs, etc. are held in a separate trust from the client's other assets, not allowing the "IRA trust" to pass to charity, and with a potential adjustment in the "non-IRA trust" for the elimination of the charity's share of the IRA trust.[3]

4. A final option which is available under the Proposed Regulations, but arguably not prior to the issuance of the same, is to provide in the client's trust document that, in the case of any trust beneficiary who at the time is the last descendant of the client then standing, it is the client's desire that said beneficiary designate X Charity as appointee under a testamentary power of appointment in the beneficiary, at least to the extent a surviving spouse or any other desirable appointee is not designated. Because permissible appointees are disregarded for trust designated beneficiary purposes under the Proposed Regulations, this option may provide a potential solution if the drafting attorney does not agree with the above analysis regarding why the charity's remote interest should be disregarded.

Individuals as Contingent Takers. If the contingent gift is to an individual or individuals, rather than to charity, and the client desires the longest deferral period possible, and with the greatest flexibility possible regarding how much of the IRAs, etc. must be withdrawn each year, they would have the following options, again depending upon whether they are already beyond their required beginning date, and depending upon whether the drafting attorney agrees with the above analysis regarding why the individuals' contingent interests should be disregarded in determining the designated beneficiary of the trust:

1. Assuming the client is already beyond their required beginning date, and the drafting attorney does not agree with the above analysis disregarding individual contingent takers

from the trust designated beneficiary determination, the client and attorney may simply allow the trust to be treated as disqualified (e.g., by not complying with the post-death documentation requirements), and allow the IRAs, etc. to be paid out over the client's remaining life expectancy. As long as the client is age 82 or younger, the period will be 10 years or longer. If the client is older than age 82, however, this option may prove to be undesirable. Life expectancy drops to five years at age 92.

2. If the client is already beyond their required beginning date and chooses not to proceed under option 1, their two options would be to either (a) rely on the analysis outlined above as to why 10-year deferral applies, with annual payments during the 10-year term based on the oldest designated beneficiary of the trust's life expectancy or the life expectancy of the client, if longer, or (b) draft the trust instrument so that IRAs, etc. are held in a separate trust from the client's other assets, not allowing the "IRA trust" to pass to any heir older than their oldest child, and with a potential adjustment in the "non-IRA trust" for the elimination of the older heirs' shares of the IRA trust.[4]

3. If the client has not reached their required beginning date their two options would be to either (a) rely on the analysis outlined above as to why 10-year deferral applies, with no annual payments required during the 10-year term, or (b) draft the trust instrument so that IRAs, etc. are held in a separate trust from the client's other assets, not allowing the "IRA trust" to pass to any heir older than their oldest child, and with a potential adjustment in the "non-IRA trust" for the elimination of the charity's share of the IRA trust.[5]

4. A final option if the drafting attorney does not agree with the above analysis disregarding individual contingent takers from the trust designated beneficiary determination would be to treat the individual contingent taker heirs as counting for designated beneficiary purposes, but limit the ages of the individual contingent takers to a specified age. For example, the client could limit the category of heir-at-law takers under the contingent gift to individuals no older than the client's oldest niece or nephew living at the time of their death, assuming the client has a niece or nephew then living. As long as the client's oldest niece or nephew is no older than age 82, annual payments during the 10-year deferral period should be no more than 1/10th per year, if the client was beyond their required beginning date, and zero, otherwise.

If the client has only one child, but no other descendants at the time of their death, the contingent takers after the death of the child are not going to be treated as remote, and therefore will be considered in determining the designated beneficiaries of the trust.

If the client only has one child, but also has at least one grandchild at the time of their death, results similar to those outlined above can be achieved provided the grandchildren are not current beneficiaries of the trust for the child's benefit during the child's lifetime, i.e., they are only secondary beneficiaries of the trust who have no current interest in the trust during the child's lifetime. Assuming the above-described reading of the Proposed Regulations is correct, under Proposed Regulation 1.401(a)(9)-4(f)(3), a contingent remainder beneficiary to the grandchildren should not be treated as having been designated as a beneficiary of the employee under the plan.

If the client has only one child, but no other descendants at the time of their death, the contingent takers after the death of the child are not going to be treated as remote, and therefore will be considered in determining the designated beneficiaries of the trust. It will therefore be impossible to achieve 10-year deferral if charity is the contingent taker, unless the two-share approach outlined above is employed. If the contingent takers are individuals, the age of oldest such individual (if older than the client's child) will be used for denominator purposes if the client dies after his required beginning date, which brings into consideration the above-outlined strategy of potentially limiting the age of the contingent takers.

Other Trust Drafting Recommendations. The planning outlined in this article thus far will turn out to be of very little consequence if it is not coupled with a strategy for taxing the income of the trust at the individual beneficiaries' tax rates, rather than at the compressed federal income tax brackets of the trust. Because distributing out the IRA, etc. income to the trust beneficiaries will of course defeat the purpose of multi-generation trust planning, Section 678 of the Internal Revenue Code must be utilized if the planning outlined in this article is to have any real benefit. The general techniques for utilizing Section 678 were first outlined

2 See Blase, "Drafting Tips that Minimize the Income Tax on Trusts – Part 2," 40 ETPL 8 (August 2013).
3 *Ibid.*
4 *Ibid.*
5 *Ibid.*

by the author 10 years ago in *Estate Planning*,[6] and last fall the author updated these techniques, also in this journal, as they applied specifically after the issuance of the Proposed Regulations.[7]

Because the existence of potential appointees under a power of appointment are considered not to be a tax deferral problem under the Proposed Regulations, if the trust is properly drafted income tax basis step-up at the beneficiary's death can now be achieved for all or a portion of the reinvested IRA, etc. proceeds payable to the trust after the account owner's death, through the employment of a general testamentary power of appointment.[8] Previously it was necessary to establish two shares for each beneficiary in order to accomplish this objective, an "IRA share" and a "non-IRA share," and it was generally impossible to achieve income tax basis step-up for the IRA share. Furthermore, the clients can now include their descendants' surviving spouses as permissible appointees by their descendants, without having to concern themselves with the potential ages of the spouses.

Finally, if the client would like to benefit charity with all or a portion of his IRAs, etc., but without shortening the deferral period for the IRAs, etc. and without significantly affecting the after-tax benefits their child or children will receive from the same, adding an IRA/charitable remainder annuity trust to the mix should be considered. Such a trust, for a term of up to 20 years, would pay the annual annuity payments to the multi-generation trust or trusts for the client's child or children, with the remainder of the IRA/charitable remainder trust corpus passing to charity at the end of the trust's term. The author has an article explaining the IRA/charitable remainder trust technique in the August 2023 issue of *Planned Giving Today*.

A Great Fit. Unlike the situation which existed previously when the client's interest in an IRA or 401k plan was made payable to a perpetual or multi-generation trust, the Proposed Regulations now specifically allow for the ready removal of contingent takers and other remote interests (including charity) from consideration in determining the designated beneficiary of the client's interest in the IRA or 401k plan account. Furthermore, by specifically authorizing the use of powers of appointment without causing a designated beneficiary problem, the Proposed Regulations allow the client to permit the beneficiary to appoint trust assets to, say, charity or a surviving spouse (regardless of age). The beneficial clarification regarding the use of powers of appointment also enables the drafting attorney to strategically and simply utilize general testamentary powers of appointment to minimize capital gain taxes at each succeeding generation, including gains on the reinvested proceeds of IRAs or 401k plan accounts made payable to the trust. All told, the Proposed Regulations appear to be a great fit for multi-generation trust planning. ■

6 *Ibid.*

7 Blase, "Estate Planning with Section 678 of the Internal Revenue Code: Part Two," 49 ETPL 10 (October 2022).

8 For a discussion of this technique, see Blase, "The Minimum Income Tax Trust," *Trusts & Estates* (May 2014).