Practical Guide
to
Drafting See-Through Trusts

Steven E. Ttrytten JD, CPA, MBA
Henderson, Caverly, Pum & Trytten LLP
Offices in San Diego, Rancho Santa Fe, and Pasadena CA
www.hcesq.com
The Stakes

- Tax-deferred compounding over a long deferral period (known as “stretch-out”) is valuable
- Case studies in materials illustrate increased economic value to beneficiary, after tax:

<table>
<thead>
<tr>
<th>Type of Plan</th>
<th>Child’s Life (pp. 36-42)</th>
<th>Grandchild’s Life (pp. 99-101)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualified plan or IRA</td>
<td>2x</td>
<td>7x</td>
</tr>
<tr>
<td>Roth IRA</td>
<td>4x</td>
<td>13 – 22x</td>
</tr>
</tbody>
</table>
Do Clients Want Trusts?

• Begin discussion as if no tax rules
• Explore specific reasons for trusts, such as:
  • special needs child
  • substance abuse child
  • spendthrift child
• Explore general reasons for trusts, such as:
  • flexibility as child grows up and circumstances evolve
  • creditor protection
  • protect assets from child’s failed marriage
  • part of family structure for family-owned assets
• Terminate at set ages, or continue indefinitely?
• Same questions for grandchildren if child predeceases
MRD Rules for Trusts

• General rule: Trusts have no life expectancy
• Exception for “see-through” trusts, treated as if the trust’s beneficiaries were designated on the death beneficiary designation (“DBD”)
• Calculate minimum required distributions (“MRDs”) using trust beneficiary with shortest life expectancy
• Subtrusts must be designated separately in order for “separate account rule” to apply (pp. 80-81)
To Qualify as a “See-Through Trust” (pp. 74-77)

- Trust must be valid under state law
- Trust must be irrevocable
- Trust beneficiaries must be identifiable, and
- Required documentation must be timely delivered to plan administrator or custodian
When You “See-Through,”
What Do You See?(pp. 77-93)

• All possible beneficiaries
• All permissible appointees under a power of appointment (“POA”)
• “Dots in the Circle” analogy (see pp. 78-79)
• If Conduit trust, disregard all dots other than current beneficiary
• Otherwise, disregard each “mere potential successor” (“MPS”)
• Narrow definition of MPS in Regs.; conservative interpretation is that a beneficiary is MPS only if preceding beneficiary entitled to all income and principal (see pp. 82-85)
Four Ways to Manage the Dots

• Conduit (p. 94)
• Outright to Next Level Beneficiaries (p. 103)
• Age Restriction (pp. 110 and 130)
• Last One Standing (pp. 115 and 135)
Designing “See-Through” Subtrusts

• Can be part of the revocable trust, a separate revocable trust, or an irrevocable trust
• Can receive retirement plan assets only, or both retirement and non-retirement assets
• Select the “see-through trust” design option for each subtrust (see following table)
<table>
<thead>
<tr>
<th>Option</th>
<th>Target Age</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Conduit</strong></td>
<td>Current Beneficiary</td>
<td>• Safe harbor in regulations</td>
<td>• Mandatory distributions</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Straightforward to draft once you’ve developed conduit clause</td>
<td>• Does not fully protect remaindermen since distributions may be large in later years</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Charities may be included as successor beneficiaries</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Beneficiary may hold power of appointment with no limitations</td>
<td></td>
</tr>
<tr>
<td><strong>Outright to Next Level Beneficiaries</strong></td>
<td>Oldest of current beneficiary and next level beneficiaries</td>
<td>• No mandatory distributions</td>
<td>• Next-level heirs must take outright, with no age or other contingency</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Straightforward to draft, but care is needed to ensure all next-level heirs take outright</td>
<td>• If beneficiary holds power of appointment, must be drafted carefully (age restriction and outright appointment)</td>
</tr>
<tr>
<td><strong>Age Restriction</strong></td>
<td>Oldest allowable age</td>
<td>• No mandatory distributions</td>
<td>• Target age arbitrarily favors younger contingent beneficiaries over older</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Beneficiary may hold power of appointment subject to age restriction</td>
<td>• Difficult to draft, especially if separate account treatment desired</td>
</tr>
<tr>
<td><strong>Last One Standing</strong></td>
<td>Oldest living member of designated class of beneficiaries</td>
<td>• No mandatory distributions</td>
<td>• All beneficiaries must be limited to designated class</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Beneficiary may hold power of appointment subject to class restriction</td>
<td>• Trust terminates when only one class member is living, even if a bad time for termination</td>
</tr>
</tbody>
</table>
“See-Through” Drafting Tips

• Restrictions should not extend to non-retirement plan assets
• Restrictions should not extend to non-stretch retirement plans
• Conduit restriction should not extend past 1st beneficiary’s life
• Restrictions should apply to accumulated plan distributions
• Avoid general references to “spouse” (p. 89)
• Define descendants carefully (p. 89)
• Pay close attention to defined terms
Case Study #1 – Outright to Children

- Oliver and Olga Olson are married with 3 well-adjusted adult children
- They have 4 grandchildren and expect more
- Each owns $1mm IRA and $6mm other assets
- Clients are not interested in multi-generational planning
- 1st death: Clients want assets to pass outright to survivor
- 2nd death: Clients want assets to pass outright to children
- If a child predeceases 2nd death, clients want assets to pass to child’s descendants in separate trusts until age 30
- Primary estate planning documents are revocable trusts
Case Study #1 – Planning Points

• DBD names spouse as primary and children as alternates (sample p. 151)
• DBD further directs deceased child’s share to subtrusts for deceased child’s descendants
• How to address possibility of future grandchildren or more remote descendants? Options:
  • Itemize subtrusts for existing descendants and update as new descendants are born (risk DBD won’t be revised)
  • Designate descendants as a class, with direction how to divide (IRA custodian/trustee may not accept class language)
  • Designate interim subtrust that handles division into subtrusts for descendants (won’t qualify for separate account rule)
  • Utilize a “Trusteed IRA” with Trustee who accepts class language
Case Study #1 – Planning Points (Cont’d)

• Benefits of alternate designation for grandchildren in DBD:
  • Preserves stretch-out over grandchild’s life if child predeceases survivor
  • Preserves disclaimer path for child
• Which “see-through trust” design for grandchildren’s subtrusts? Conduit clause is simplest
• Effort may be needed to coordinate with financial institution when subtrust assigns plan account to grandchild at age 30
• Revocable trust should include tax apportionment language allowing death taxes on retirement plan assets to be paid from that beneficiary’s share of revocable trust assets and/or funds advanced by that beneficiary
Case Study #2 – Forced Stretch-Out

• Frank and Frieda Furman present same facts as Case Study #1, except they want their children to take only MRDs
• Non-IRA assets will still pass outright
• IRA assets will pass to subtrusts that distribute just the MRD (or more if trustee deems appropriate)
• Conduit is an excellent match with clients’ objectives
• DBD names spouse as primary and children’s subtrusts as alternate
• Including alternate designation for grandchildren’s subtrusts:
  • Preserves stretch-out over grandchild’s life if child predeceases survivor
  • Preserves disclaimer path for child
• Trusteed IRA is another way to do this
Case Study #3 – Forced Stretch and Charity

• Frank and Frieda Furman (Case Study #2) also direct that at each child’s death, any remaining subtrust assets pass to charity
• Conduit is the only see-through trust option, since it is the only option that allows a charity to be disregarded in determining the measuring life for calculating MRDs
• DBD would designate spouse as primary and subtrusts for children as alternate
• Trusteed IRA is another way to do this
Case Study #4 – Special Needs Trust

• Stan and Sylvia Smith present same facts as Case Study #1 except disabled middle child receives government benefits
• Conduit not an option for middle child (mandatory distributions)
• Simplest design is Outright to Next Level Beneficiaries:
  • At middle child’s death, special needs subtrust must pass outright **with no age restriction or other contingency**
  • Subtrust passes to middle child’s issue, if any, otherwise to other children (or their issue if child predeceases)
  • Perhaps UTMA to age 21 is allowable, but no specific guidance
  • MRDs will be calculated using oldest child’s life expectancy
• See-through trust alternatives are discussed in case study #6
• Trusteed IRA is not an option since it cannot accumulate MRDs
Case Study #5 – Creditor Protection

- Carl and Cheryl Clark present same facts as Case Study #1, except they want trusts that will protect inheritances from the beneficiary’s creditors
- Subtrusts will generally reflect creditor protection provisions
- Conduit is simplest design
  - Comparable to outcome if applicable law protected inherited IRAs
  - However, MRDs are exposed. MRDs may get large in later years
- Outright to Next Level Heirs avoids exposure of MRDs, but entire trust is exposed when it passes outright at death of primary beneficiary
- Alternatives (discussed in case study #6):
  - Age restriction
  - Last one standing
- Dynasty Trust considerations discussed further below
Case Study #6 – Discretionary Trusts

• Don and Dolores Davidson present the same facts as Case Study #1, except they want flexible, fully discretionary trusts for their children and more remote descendants

• Conduit design is not an option (cannot accumulate MRDs)

• Trusteed IRA is not an option (cannot accumulate MRDs)

• Outright to Next Level Beneficiaries is not an option (outright distribution at child’s death)
Case Study #6 (Continued)

- Decide between Age Restriction and Last One Standing:
  - Age Restriction limits to individuals at or under a specific age
  - Last One Standing is even more limited, since it is limited by age of oldest descendant and by membership in the class of descendants
  - Oldest age may governs MRDs for each child’s trust (no separate account rule), unless complex drafting of cross-over provisions
  - Either approach may arbitrarily exclude some alternate beneficiaries
  - Last One Standing terminates when only one descendant is living, even if it is a bad time for trust to terminate
- Age restriction may be best, since it avoids unexpected termination
- Remember, design limitations should only be imposed on stretch-out retirement plans and accumulations
- Dynasty Trust considerations discussed further below
Case Study #7 – Non-Exempt Dynasty Trust

- Nick and Nancy Norris are married with 3 well-adjusted adult children
- They have 4 grandchildren and expect more
- Each owns $2mm IRA and $20mm other assets
- Clients are interested in multi-generational planning
- GST exemptions not available for retirement assets
- 1st death: Retirement assets designated to spouse
- 2nd death: Retirement assets designated to non-exempt dynasty trusts for children and more remote descendants
- Primary estate planning documents are revocable trusts
Case Study #7 – Planning Points

- Outright to Next Level Beneficiaries not an option
- Conduit is nice option if mandatory distribution of MRDs is acceptable (but remember, MRDs grow large in later years)
- Conduit also supports separate account treatment so each child uses his/her life (DBD must designate each subtrust separately)
- Conduit allows power of appointment ("POA") with creditors, estate, or creditors of estate ("CECE") as permissible recipients
- This is an important benefit, since POA is often used as a tool to fine-tune whether trust assets are subject to estate tax or GST tax at primary beneficiary’s death
Case Study #7 – Planning Points (Cont’d)

• If mandatory distribution of MRDs is not acceptable, then choose between Age Restriction or Last One Standing

• Age Restriction or Last One Standing likely to result in oldest life governing all children’s trusts

• Age Restriction and Last One Standing require individual recipients, so POA cannot use CECE

• What alternatives to POA using CECE?
  • Primary beneficiary may withdraw with consent of non-adverse party
  • Delaware Trap
Case Study #8 – Exempt Dynasty Trusts

- Ed and Ellie Epstein present same facts as Case Study #7, except they want retirement assets to be designated to Exempt dynasty trusts at 2nd death. GST exemption will be available.
- Outright to Next Level Beneficiaries not an option
- Conduit option is workable, per above, but:
  - Not as tax-efficient since exempt MRDs “leak out”
  - Not needed for POA, since it won’t be necessary to include CECE
- For best results, choose between Age Restriction and Last One Standing
- No need to include alternatives to POA with CECE
Case Study #9 – Flexible Dynasty Trusts

• Fred and Felicity Flexible present same facts as Case Study #7, except they want to preserve flexibility for successor trustee at 2nd death to fund Exempt or Non-Exempt dynasty trusts with any mix of retirement and non-retirement assets allowed under the GST regulations

• One subtrust per child arises under revocable trust that is severed into two subtrusts per Treas. Regs. 26.2654-1(b)(1)

• One new subtrust receives allocation of GST exemption and the other does not (known as “Exempt” and “Non-Exempt”)
Case Study #9 – Planning Points

• Brief review of GST regulations:
  • Assets of original subtrust are divided on a pecuniary basis only if required in governing instrument, with assets divided in a “fairly representative” manner and appropriate interest paid
  • Otherwise assets are divided on a fractional basis; may be non pro rata based either on date of funding values or “fairly representative” manner
  • The two new subtrusts may have differing provisions, so long as the terms in the aggregate provide for the same succession of interests and beneficiaries as provided in the original subtrust
  • For example:
    – Trustee may distribute first from Non-Exempt Trust, and
    – Non-Exempt Trust may include a mechanism to determine whether estate tax or GST tax applies at primary beneficiary’s death
Case Study #9 – Planning Points (Cont’d)

• The only safe way to comply with GST regs. and see-through trust rules is to either:
  – Make sure portions of retirement plan assets passing to Exempt and Non-Exempt Trusts are hard-wired in death beneficiary designation or plan document (for example, Trusteed IRA might incorporate a formula); or
  – Make sure Exempt and Non-Exempt Trusts have same beneficiaries and succession of interests, which means they use same see-through trust technique

• Revocable trust should direct division on fractional, not pecuniary basis, to ensure there is no taxable income on division

• If non pro rata division of retirement and non-retirement assets is contemplated, consider adding language to revocable trust to clarify how retirement assets are valued
  – For example, clause might provide that assets to be divided are valued with no downward adjustment for deferred income tax and no upward adjustment for preferential income tax treatment
Case Study #9 – Planning Points (Cont’d)

• If retirement plan is designated to Dynasty Trust (pre-split), Beneficiaries and permissible recipients (“dots in the circle”) of original subtrust analyzed by looking through both Exempt and Non-Exempt subtrusts that arise on severance
  – Thus, POA of non-exempt trust cannot allow CECE as permissible recipients
  – This undermines benefit of Conduit; best to choose between Age Restriction or Last One Standing for both Exempt and Non-Exempt subtrusts

• Oldest life likely to control for all children

• Decanting – be careful that clauses that allow decanting or other modifications do not allow other beneficiaries or permissible recipients; in other words, “no new dots!”
Case Study #9 – Planning Points (Cont’d)

• Trusteed IRA as possible alternative:
  • Document can include more complex provisions that a financial institution might otherwise not accept
  • Thus, designation can include formula clause that allocates between exempt and non-exempt subtrusts for each child
  • Shares that do not accumulate MRDs could operate under the Trusteed IRA; otherwise, shares must pass to subtrusts arising under outside Will or trust documents
Case Study #10 – GST Amount to Grandchildren

• George and Gigi Greggson are married with 3 well-adjusted adult children
• They have 4 grandchildren and expect more
• Each owns $8mm IRA and $30mm other assets
• 1st death: Retirement assets designated to spouse
• 2nd death: Clients want maximum amount sheltered by GST exemptions to pass in Exempt dynasty trusts for grandchildren, balance in Non-Exempt dynasty trusts for children
• Primary estate planning documents are revocable trusts
Case Study #10 – Planning Points

• Fund grandchildren’s Exempt dynasty trusts with retirement or non-retirement assets? (see pp. 42-44)
  • Case study illustrates choosing retirement yields 2.5x benefit
  • Case study illustrates choosing Roth IRA yields 6-10x benefit

• If clients decide to fund with retirement, what options to fund correct amount without exceeding available GST exemption? (see pp. 147-149)
  • Maintain separate IRA or Roth IRA in amount that is close to target and review periodically
  • Disclaimer may be an option, but logistics will be challenging
  • “Damn the torpedoes” and pay GST Tax, especially if Roth IRA
  • Trusteed IRA that includes formula clause
Case Study #10 – Planning Points (Cont’d)

• Exempt dynasty trusts for grandchildren better as Conduit, or better as either Age Restriction or Last One Standing?
  • Conduit supports separate account treatment with each grandchild using his/her own life to calculate MRDs, but Exempt MRDs leak out. MRDs may grow large in later years
  • Age Restriction imposes specific age on all Exempt subtrusts and excludes older individuals; if oldest grandchild’s age is specified, children will be excluded
  • Last One Standing imposes oldest class member’s age on all subtrusts; to obtain oldest grandchild’s life, class may need to be defined as excluding children
• Non-Exempt dynasty trusts for children better as Conduit, or better as either Age Restriction or Last One Standing?
  • Conduit will be simpler (allows standard POA with CECEs), and also supports separate account treatment
Case Study #11 – Ultra-High Net Worth

• Walter and Wendy Welloff are married with 3 well-adjusted adult children
• They have 4 grandchildren and expect more
• Each owns $2mm IRA and $200mm other assets
• Clients are very interested in minimizing taxes and in multi-generational planning
• Sophisticated tax and estate planning is in place with respect to all non-retirement assets
• No planning has been done with retirement assets
• What planning options should be explored for retirement assets?
Case Study #11 – Planning Points

• High net worth individuals have access to exotic investments
  • Watch for UBTI, prohibited transactions, and impermissible investments
  • Watch for valuation issues in calculating MRDs
• Grandchildren are unlikely beneficiaries in this case, as GST exemptions are likely being used for non-retirement assets
• Should retirement plan assets pass through the same trust structures that are in place for non-retirement assets?
  • This normally makes sense, especially for large retirement plans
  • May complicate documents (see dynasty trust case studies)
  • For modest retirement plans (relative to total estate, as in this case), designating children outright may be a blow for simplicity
Case Study #11 – Planning Points (Cont’d)

- If clients are liquid, explore Roth IRA conversions
- If applicable, explore whether retirement plan assets can be applied to equalize gifts to child who is not sharing in family business or real estate assets
- Better to use retirement plans to fund charitable gifts? Not necessarily – see pp. 175-183
- “Spouse-skipping” – spouse doesn’t need the money, so consider leaving to children at first death
  - May increase deferral if children’s MRDs are less than spouse’s MRDs
  - However, better for spouse to take Roth IRA and rollover, as spouse will have no MRDs at all
  - Address death tax apportionment to avoid charging retirement plan
Roth IRA Pointers

- Roth IRA conversion provides spectacular benefit to heirs from an estate and multi-generational planning standpoint
- Consider Roth IRA conversion as a pre-mortem planning strategy
- For Roth IRA owner more concerned about his/her retirement than heirs:
  - Consider a blend of regular and Roth IRA plans
  - Blend requires less up front cash to pay tax on conversion
  - Blend allows fine tuning of taxable income from year to year
  - Blend does not preclude further Roth IRA conversions if desired
  - Blend diversifies planning techniques
  - Roth IRA portion provides “back-loading” to preserve more plan assets if client needs more assets in later years
Roth IRA Pointers (Cont’d)

• For any client contemplating Roth IRA conversion, review their charitable intentions

• If percentage limitations on charitable deductions are an issue, make use of higher AGI in year of IRA conversion
Roth IRA Pointers (Cont’d)

• If an asset is hard to value (and perhaps requires discount), coordinate with IRA custodian/trustee to arrange appraisal

• Roth IRA may postpone the need for annual appraisals of hard to value assets to calculate MRDs (since no MRDs during owner’s lifetime)