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The SECURE Act, Trusts, Corporations and CRTs

Introduction

This article discusses some of the complications that have arisen because the SECURE Act[1] eliminated so-called "lifetime stretch" payments from a qualified (retirement) plan or an IRA (each a "Plan") for most beneficiaries, especially where it is desirable to have the payments made to and possibly kept in a trust. Specifically, among alternatives considered is the possibility of creating a trust described in Section[2] 678 ("Section 678 Trust") for the individual intended to be benefited by the Plan. Another possibility is naming an S corporation the beneficiary of a Plan where the shareholders of the S corporation include or consist exclusively of one or more qualified subchapter S trusts[3] ("QSSTs") for the individual or individuals intended to be benefitted by the Plan. At least one of the reasons for these potential beneficiary designations is so that Plan distributions will be subject to income tax at the rates applicable to individuals rather than at the compressed rates that apply to non-grantor trusts[4].

A Section 678 Trust may hold significant promise for some although it may raise issues not confronted when using a QSST. Nonetheless, as discussed in detail below, if a QSST is used, it seems that the Plan benefits might be required to distributed by the end of the fifth calendar year following the year of the death of the IRA owner or employee of a qualified plan (each a "Plan Holder") rather than at the end of the tenth calendar year following the Plan Holder's death.

Some Benefits and Burdens of Trusts

[1] The "SECURE ACT" is the nickname for Section 401 of Title IV – Revenue Provisions of "Division O" (Setting Every Community up for Retirement Enhancement) of the Further Consolidated Appropriations Act, 2020, signed into law on December 19, 2019.

[2] Throughout this article, references to a "Section" is to a section of the Internal Revenue Code of 1986, as amended through April 30, 2020, except where otherwise noted.

[3] Such a trust is described in Section 1361(d).

[4] A non-grantor trust is one that is not a deemed owner trust (commonly called a "grantor trust)" under the provisions of subpart E of part 1 of subchapter J of Chapter 1 of the Internal Revenue Code of 1986 as amended ("Code").

Trusts serve many purposes including providing asset protection and avoiding unwise dissipation of wealth.[5] In addition, trusts may provide the best opportunity to reduce estate, gift and generation-skipping transfer tax.[6] Trusts also may offer the most efficient platform for income tax planning as a result of the ability to shift income from the trust to its beneficiaries[7] and to do so within 65 days after the close of the trust's tax year,[8] and to avoid state income taxes.[9] Income which is taxed to the trust will likely face high federal income taxes. In 2020, the taxable income of a trust above $12,950 will be taxed at the highest federal rate (37% on ordinary income) and subjected to the net investment income tax under Section 1411 of 3.8%, although this latter tax does not apply to Plan distributions.[10] Individuals face those rates essentially only when their incomes exceed $500,000 and $200,000, respectively.[11]

Impacts of SECURE Act Changes on Trusts

The SECURE Act has ended the ability, for many beneficiaries, to "stretch" distributions from a Plan over a long period of time, based upon the fixed (unrecalculated) life expectancy of an identified individual beneficiary (called the "Designated Beneficiary"), either directly or through a so-called "see-through trust" for the individual.[12]

Under the SECURE Act, see-through trusts may continue to be used for any Designated Beneficiaries, but the Plan must be entirely distributed not later than the end of the tenth calendar year[13] after the calendar year of the death of the IRA owner or plan participant, except where the beneficiary falls in one of five categories of individuals called "Eligible Designated Beneficiaries" or "EDBs". (Payments may also be made over the remaining life expectancy of the Plan Holder who dies after reaching his or her required beginning date ("RBD"), which is when he or she must begin withdrawing required minimum distributions ("RMDs") or face extra taxes imposed by Section 4974.)

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[5] See Blattmachr & Blattmachr, "Even Without Estate Tax, the Right Answer Still Is: Put It All In Trust," Alaska Trust Company Newsletter (June 2011).
[6] Blattmachr, "The Right Answer: Put It All In Trust," Trust & Investments, (Sept/Oct 1998), republished in 10 NYSBA Elder Law Attorney 12 (Winter 2000).
[7] See Sections 651-652 and 661-662.
[8] See Section 663(b). There are many other distinctions between the taxation of trusts and other entities such as the allowance of an income tax deduction for a trust under Section 642(c); see, generally, Blattmachr, Boyle & Fox, "Planning for Charitable Contributions by Estates and Trusts", 44 Estate Planning 3 (January 2017).
[9] See, generally, Blattmachr & Shenkman, "State Income Taxation of Trusts: Some Lessons of *Kaestner*," 46 Estate Planning 3 (Oct 2019); Gans, "*Kaestner* Fails: The Way Forward," 11 Wm. & Mary Bus. L. Rev. 651 (2020). State income taxation may be avoiding by using an electing small business trust described in Section 641(c). See, generally, Boyle, Blattmachr & Gans, "Planning Opportunities with ESBT's: Saving State and Local Income Taxes," 129 J. of Tax'n 20 (July 2018).
[10] Section 1411(b)(5) and see, generally, Blattmachr, Gans & Zeydel, "Imposition of the 3.8% Medicare Tax on Estates and Trusts," 40 Estate Planning 3 (April 2013).
[11] Sections 1 and 1411, respectively.
[12] See Section 401(a)(9) before and after the effective date of the SECURE Act.
[13] This means that payments may be received, in general, over 11 calendar years. For example, if the Plan Holder dies in 2021, the tenth calendar year following the death is 2031, so there are 11 calendar years, including the year of death, to receive payments under the ten-year rule. Similarly, there will be six calendar years to receive Plan Distributions under the five-year rule discussed in the text. However, if the Plan Holder dies late in a calendar year, it likely will not be possible to receive a distribution in that year.

See-through trusts consist of what are called "Conduit Trusts" and "Accumulation Trusts" and are commonly referred to as "see-through trusts" because one may look through the trust to find the Designated Beneficiary.[14] A Conduit Trust is one that mandates that all Plan distributions be paid out immediately to the identified individual beneficiary of the trust. An Accumulation Trust may pay or accumulate Plan Distributions although all beneficiaries of the trust must be identified individuals (by name or description) and are called "Designated Beneficiaries."

Here is a key takeaway: If the Plan Holder wants the Plan proceeds to pass into and stay in trust for asset protection or other reasons, an Accumulation Trust may be used; however, all the Plan proceeds must be distributed within ten years after the year of the death of the Plan Holder (unless the individual trust beneficiary is in a certain category of EDB, as discussed below).[15] Moreover, it is virtually certain, in almost all cases, that if a non-grantor trust is the direct recipient of the Plan proceeds and does not distribute them, the trust will face higher federal income taxes under the compressed trust rates than would an individual beneficiary.[16] Thus, if a trust is desired, the question might be whether a trust taxable under Section 678, with an individual deemed owner of the trust, or an S corporation, with a QSST shareholder, may be used to mitigate the income tax burden of Plan proceeds distributed in trust.

Eligible Designated Beneficiaries

EDBs consist of (1) the surviving spouse of the Plan Holder (again, the plan participant or IRA owner); (2) chronically ill persons defined in Section 7702B(c)(2); (3) disabled persons as defined in Section 72(m)(7); (4) persons not more than 10 years younger than the Plan Holder;[17] and (5) minor children of the Plan Holder.

An EDB is permitted to withdraw Plan assets over his or her fixed (unrecalculated) life expectancy which must begin in the calendar year following the year of the Plan Holder's death,

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[14] For a thorough discussion of these trusts, see Choate, LIFE AND DEATH PLANNING FOR RETIREMENT BENEFITS, 8th Ed., at 6.3.05 and 6.3.07.

[15] If payable to a Conduit Trust, the Plan distributions need not be made for ten years (if the 10-year rule applies) but the distribution must be distributed immediately to the individual trust beneficiary foiling the premise of keeping them in trust. If the life expectancy rule applies (because the beneficiary is an EDB), distributions must commence the year following the date of the Plan Holder. See Choate, "Drafting See-Through Trusts After the SECURE Act," 159 Trusts & Estates 36 (April 2020).

[16] If Plan proceeds are payable to a beneficiary, or to a see-through trust for the benefit of a beneficiary (such as a Conduit Trust or, for a Disabled or Chronically Ill person an Accumulation Trust), who will not reach the age of least 19 (or 24 if still a student) during the year, the so-called Kiddie Tax provisions may apply if, among other conditions, the beneficiary has at least one living parent at the end of the year. Section 1(g)(4)(C). The Tax Cuts and Jobs Act of 2017 provided for unearned income of children under the age of 19 (or 24 if the child were still in school (as specified in Section 1) to be taxed at the compressed rates applicable to estates and trusts, which reach the maximum income rate and net investment income threshold once taxable income exceeds $12,950 (inflation adjusted). The SECURE Act repealed this provision and goes back to pre-TCJA provisions (but only through 2025) so the unearned income of such a child is taxed at the parents' marginal rates. Under these Kiddie Tax rules, the unearned income of the child not only will be taxed at the parent's marginal rates (which may still be below the top rate the trust would reach for income above $12,950), the parent can opt, under certain conditions, to include that income as the parent's own and pay the tax on that income. The parents do that only if the unearned income consists of interest and dividends (including the Alaska Permanent Fund Dividends). Section 1(g)(7).

[17] Section 401(a)(9)(E)(ii) of the Code.

except in the case of the Plan Holder's surviving spouse or minor child. A surviving spouse may delay taking RMDs until the year after the year of the Plan Holder's death or, if later, the year in which the Plan Holder would have reached age 72. However, the only way the surviving spouse may delay taking RMDs until the surviving spouse's own RBD is if the surviving spouse rolls over the benefits to the surviving spouse's own IRA, which the surviving spouse may only do if the surviving spouse is named outright as the beneficiary of the Plan; a Conduit Trust for the surviving spouse does not permit such a rollover. If the Plan proceeds are left to the spouse outright, and the spouse rolls them over to an IRA, the surviving spouse may then take withdrawals (starting at age 72) using the Uniform Lifetime Table (ULT), as opposed to using the surviving spouse's recalculated life expectancy.[18] The ULT is a joint life table which is more favorable than the single life table applicable to a Conduit Trust. If the Plan proceeds are left to an Accumulation Trust, RMDs may not be based upon the life expectancy of the surviving spouse, and instead, the 10-year payout rule will apply.[19]

In the case of Plan proceeds payable to a minor child, the 10-year payout rule also will not apply until such date when the minor child reaches the age of majority. Once the minor child reaches the age of majority, the 10-year rule will commence.[20] If an Accumulation Trust is used from inception, the Plan proceeds must be distributed under the 10-year payment rule because the minor child would not be treated as the sole beneficiary of the Plan (unless Disabled or Chronically Ill).

Non-Designated Beneficiaries

Just as was the case before the SECURE Act, if any of the Plan distributions must or may be paid to a person which is not a Designated Beneficiary (e.g., a corporation, an estate, a partnership or any trust that is not a see-through trust), all Plan distributions must be taken out by the end of the fifth calendar year following the year of death of the Plan Holder.[21]

Bunching of Income and Other Problems

In all cases, distributions may be delayed until the end of whichever of the ten-year or five-year payment rules applies. Delaying income taxation often is beneficial, but it may be preferable to

[18] See Choate, "Drafting See-Through Trusts After the SECURE Act," 159 Trusts & Estates 36 (April 2020) for a discussion of these rules as they exist after the SECURE Act changes.
[19] Id.
[20] Some advisers think that, perhaps, if a Conduit Trust is used for a minor child, the trust may convert to an Accumulation Trust when the minor child attains majority. However, this seems inconsistent with Reg. 1.401(a)(9)-5, A-7(c)(3) although that regulation was enacted prior to the SECURE Act.
[21] Under the "at least as rapidly rule" under Reg. 1.401(a)(9)-5, A-5(a)(2), if the Plan Holder dies after the RBD and there is no Designated Beneficiary, distributions must be taken over her his or remaining life expectancy under the Single Life Table under Reg. 1.401(a)(9)-9 and the five-year payout period does not apply. An individual has more than a five-year remaining life expectancy until after age 91. Throughout this article, any reference to the five-payout rule include reference to the "at least as rapidly rule" if the Plan Holder has reached his or her RBD. It is uncertain how any "at least as rapidly" rule will be applied where the ten-year payout rule otherwise would apply.

take Plan distributions over more than one year to spread out the income over several years, which may reduce the applicable tax rates.[22]

In order to comply with the special stretch rules for an EDB, the Plan distributions, in general, must be made directly to the EDB or to a Conduit Trust for him or her. (Only a Disabled or Chronically Ill EDB may receive Plan distributions over the beneficiary's life expectancy using an Accumulation Trust. [23]) If the Plan distributions are made directly to the individual, then they all will be taxed to the individual (and, because they do not represent interest or dividends, the tax on them cannot be paid by the parents of a Disabled or Chronically Ill beneficiary under the Kiddie Tax rules[24]). An individual, in general, will face lower income taxes (at least Federal income taxes) than would a non-grantor trust.[25] If the Plan Distributions are paid to a Conduit Trust for the EDB, each Plan distribution (whether or not it is a RMD) must in turn immediately be distributed to the EDB who is the trust beneficiary and will be taxed to the beneficiary (unless the distribution is from a Roth IRA described in Section 408A) just as if the Plan distribution had been payable directly to him or her without a trust.

Although it seems that an Accumulation Trust may be used for a Disabled or Chronically Ill EDB with Plan distributions made over his or her life expectancy, that is not the case for a surviving spouse of the Plan Holder, a minor child of the Plan Holder or a beneficiary who is not more than ten years younger than the Plan holder. Instead, to obtain the benefit of a "stretch" payment over the life expectancy of the surviving spouse, minor child or beneficiary who is not more than ten years younger, the Plan distributions must be paid directly to them or to a Conduit Trust which will be required immediate payment of all Plan distributions over to the beneficiary.[26]

Paying the Plan distributions directly to the EDB or to a Conduit Trust for the EDB may cause a Disabled or Chronically Ill EDB to lose government benefits because the EDB may then have reached the income/asset threshold that will cause benefit ineligibility.[27] Therefore, an Accumulation Trust is permitted for a Disabled or Chronically Ill EDB. This seems to be the case even if the income of a minor Chronically Ill or Disabled beneficiary is taxed at the parents' rates under the Kiddie Tax rules of Section 1(g). However, if Plan distributions are paid to an Accumulation Trust for the EDB, the distributions will be taxed to the trust at the highest income

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[22] For a Roth IRA, described in Section 408A, it usually will be best to wait until the end of the period as distributions generally will not be included in gross income and leaving Plan proceeds in the Roth IRA will permit further tax-free accumulation.

[23] See Choate, "Drafting See-Through Trusts After the SECURE Act," supra.

[24] See note 16.

[25] A grantor trust is one the income, deductions and credits against tax of which are attributed to the grantor or other income tax owner. See Sections 671-679. A trust that is not grantor trust is taxed as a separate taxpayer under special rules primarily under subchapter J of Chapter 1 of the Code.

[26] See Choate, Life and Death Planning for Retirement Benefits, 8th Ed., at 6.3.05.

[27] The income and asset value levels are relatively low, subject to exceptions and special rules. See, generally, Feke, "Medicaid Eligibility: MAGI and Your Assets," available at https://www.verywellhealth.com/your-assets-magi-and-medicaid-eligibility-4144975.

tax rate to the extent taxable income exceeds $12,950 if not distributed or treated as distributed to or for the benefit of the EDB.[28]

A Section 678 Trust Might Help

It has been the official position of the IRS and the Treasury for decades that the existence of a grantor trust (a so-called "deemed owner" trust[29]) is ignored and the deemed owner is treated as owning the assets held by the trust for Federal income tax purposes.[30] Thus, if Plan proceeds are payable to a trust taxed as a deemed owner trust under Section 678, the Plan should be treated as owned by the trust's deemed owner.

However, the Internal Revenue Service has never issued any ruling on the application of the grantor trust rules to Plans.[31] It seems that a see-through trust (that is, a Conduit Trust or, with respect to a Disabled or Chronically Ill beneficiary, an Accumulation Trust) , whether or not it is a deemed owner trust, should qualify for the ten-year payment rule or for EDBs for an even more extended period. The IRS has at least once endorsed a statement that a grantor trust could not own a Plan, although the situation apparently involved to a grantor trust during the Plan Holder's lifetime.[32] Still, it seems virtually certain that making a Plan payable to a Section 678 trust for a

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[28] See Section 1(e) and Section 651, 652, 661 and 662. If the EDB is disabled, the trust possibly could be structured as a Qualified Disability Trust (QdisT) within the meaning of Section 642(b)(2)(C) which is entitled to a personal exemption of2$4,250 (inflation adjusted). Moreover, it may be especially helpful if the beneficiary is a child whose unearned income would otherwise be taxed at the marginal rates of the child's parent(s) under the Kiddie Tax. A Qualified Disability Trust not only enjoys a personal exemption of $4,150 (inflation adjusted) through 2025 but, by making distributions of the balance of the income to the child, could be taxed at the child's rate (because the Kiddie Tax does not apply to distributions from a QdisT as they are treated as earned income of the child who is the beneficiary) and essentially using a $12,000 standard deduction because the income from a QDisT is considered earned income. This all will be beneficial unless the child has extremely high income (essentially, more than $500,000). (State income taxes also should be considered.) A QdisT is available only if the beneficiary is under age 65 when it is created and the beneficiary has been determined by the Commissioner of Social Security to be disabled for some portion of the year. The definition of disabled is the same for the SECURE Act as it is for a QdisT. As indicated, to the extent the QDisT makes distributions of its taxable income to the beneficiary to have income taxed at the beneficiary's lower rates, creditor protection and government benefits may be lost.

[29] Although such deemed owner trusts are almost universally called "grantor trusts" that is not what the Code provides. Rather, Section 671 specifies that the grantor, when the conditions set forth in Sections 673 to 677 and 679 are met, or a trust beneficiary who is not the trust grantor, when the conditions set forth in Section 678 are met, will be treated as the owner of the trust.

[30] See Rev. Rul. 85-13, 1985-1 CB 184, and especially Example 5, Treas. Reg. 1.1001-2 ("C, an individual, creates T, an irrevocable trust. *** T is a 'grantor trust'… and therefore C is treated as the owner of the entire trust. *** Since … C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes ….").

[31] See Choate, Life and Death Planning for Retirement Benefits, 8th Ed., at 6.3.10 ("If an individual U.S. citizen- or resident-trust beneficiary is deemed the owner of all of a trust's assets under 678(a)(1), then retirement benefits payable to such trust *should* be deemed paid 'to' such beneficiary for purposes of the minimum distribution rules, and the 'all beneficiaries must be individuals' test would therefore be met. However, there is no ruling on point." Compare discussion in Horwitz & Damicone, "A Decent Proposal," 150 Trusts & Estates 46 (Nov. 2011).

[32] See PLR 201129045(not precedent), stating without analysis or citation that an IRA will lose its tax deferred status if contributed to a grantor trust; *but, cf.,* CCA 201334021 (which seems critical of the statement in the private letter

person who would be a DB should qualify for the ten-year payout rule by reason of the trust's see-through status.

To be a so-called Section 678 trust, the beneficiary must have a unilateral right to withdraw the entire trust estate,[33] meaning creditor protection almost certainly will be lost, at least in many states.[34] Also, if the beneficiary is disabled and entitled to government benefits, even if the power of withdraw is allowed to lapse (or is released) will cause a period of ineligibility for the beneficiary of those benefits, in most cases.[35] If the power to withdraw is partially released or otherwise modified, and does not entirely disappear, the trust will remain a Section 678 trust.[36] Hence, if the beneficiary is permitted to and does modify the power (perhaps, so it can only be exercised only with the consent of another person or only for supplemental needs), it should mean the trust is still a Section 678 trust, so that the beneficiary, and not the trust, will be taxed on all Plan proceeds at the beneficiary's rates, but without the need to actually make Plan distributions to the beneficiary.[37]

Thus, using a Section 678 trust would likely produce the best overall income taxation although it does raise creditor rights issues. It also raises the specter of possible estate tax inclusion for the

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ruling). Neither a private letter ruling nor a chief counsel advisory (CCA) may be cited or used a precedent. Section 6110(k)(3).

[33] See Blattmachr, Gans & Lo, "A Beneficiary as Trust Owner: Decoding Section 678." 35 ACTEC J. 106 (2009).

[34] "Although the Restatement of the Law Third, Property, Wills and other Donative Transfers and the Uniform Powers of Appointment Act, both provide that property subject to a presently exercisable general power of appointment is subject to claims of the powerholder's creditors to the same extent that it would be subject to those claims if the property were owned by the powerholder, Alaska statutorily adopted the position of the Restatement of the Law Second of Property: Donative Transfers § 13.2 cmt. a (1986). The Restatement Second adheres to the common-law rule that the powerholder's creditors cannot reach appointive assets covered by an unexercised general power of appointment until such time that the power is exercised. The rationale is that until the powerholder exercises the power, the powerholder has not accepted sufficient control over the appointive assets to give the powerholder the equivalent of ownership of them." Unpublished article by Stephen E. Greer of Anchorage, Alaska. The Alaska Statute 34.40.115 reads: Subjecting Appointed Property to Claims of Donee's Creditor. The property that a donee of a power of appointment is authorized to appoint is not subject to the claims of the creditors of the donee except to the extent that a donee of an inter vivos or testamentary power of appointment (1) is permitted by the donor of the power to appoint the property to the donee, the creditors of the donee, the donee's estate, or the creditors of the donee's estate; and (2) effectively exercises the power of appointment in favor of the donee, the creditors of the donee, the donee's estate, or the creditors of the donee's estate. Other states have similar rules protecting property from the claims of creditors of the power holder who holds an unexercised power of withdrawal.

[35] First party special needs trusts are ones created by the beneficiaries for themselves. Third party special needs trusts do not have a specific statutory exemption but POMS SI 01120.200(D)(2) provides that, if the beneficiary does not have the legal authority to revoke or terminate the trust or to direct the use of the trust assets for his or her own support and maintenance, the trust principal is not the individual's resource for social security benefit purposes.

[36] See Section 678(a)(2) and PLR 200944002 (not precedent). Note that if the power to withdraw lapses or is release, the powerholder may be treated as making a transfer to a so-called "self-settled" trust which, under the law of a majority of states, means the property will be subject to the claims of his or her creditors. However, that is not the case currently in 19 states. See ACTEC Comparison of Domestic Asset Protection Trust Statutes (Shaftel, ed.), available at Shaftellaw.com. Hence, at least general creditor protection may be available for a beneficiary who allows the power over the Section 678 Trust to allow it to lapse or to modify it but, as mentioned in the text, may cause a long period of disallowance to government benefits.

[37] Under Section 678(d), the section is not applicable if the powerholder renounces the power within a reasonable time after learning of the power. Hence, the beneficiary should be advised of it.

beneficiary although this may be of secondary importance to the potential immediate reduction of income taxation on the Plan proceeds, particularly if the trust otherwise would be subject to transfer tax (e.g., generation-skipping transfer tax) on the beneficiary's death in any event.

One final thought about Section 678 trusts. Although the deemed owner of the Section 678 trust (just as in the case of the grantor of a grantor trust) is deemed for all income tax purposes to own the assets of the trust, it does not mean with complete certainty that the deemed owner is the sole beneficiary of the trust for purposes of Section 401(a)(9). So, if a Disabled Person is the deemed owner under Section 678 of the trust that is the Plan beneficiary, it does not mean with certainty that the payout over the life expectancy of the Disabled Person will apply. However, it seems that if the trust is structured as an Accumulation Trust for any designated beneficiary (whether or not an EDB), it will qualify for the ten-year payout rule whether or not Section 678 is applicable.

A Qualified Subchapter S Trust May Help Even More

Only US individual taxpayers, their estates and certain trusts may hold shares in an S corporation, the income of which is taxed directly to its shareholders.[38] A QSST is a permitted S corporation shareholder. To be a QSST, the trust must have only one beneficiary who is a US individual income taxpayer, must be required to or does, in fact, distribute all of its fiduciary accounting income (FAI), within the meaning of Section 643(b), each year to that beneficiary, and the beneficiary must elect to be treated as the income tax owner under Section 678[39] (essentially as though it were a grantor or deemed owner trust as to the beneficiary) of the portion of the trust that consists of the qualifying S stock and, thereby, be treated as its shareholder. One of the effects of a QSST is that the income of the S corporation is treated as being that of the shareholder (in this case, the beneficiary of the QSST), although this rule does not apply to taxable income resulting from the sale of the S corporation stock. [40]

Plan proceeds can be made payable to an S corporation[41] which has a QSST as its shareholder, where the Plan Holder wants the individual trust beneficiary to benefit from the Plan proceeds. That means the Plan proceeds will be income of the S corporation and thereby will be included in the gross income of the trust beneficiary. This income will be taxed to the trust beneficiary whether or not she receives anything other than trust FAI and the S corporation's income will not be in FAI unless the S corporation makes a distribution that constitutes FAI (as most dividends would[42]). Note that this may mean that the Plan proceeds will be taxed to the QSST individual beneficiary (as noted they cannot be taxed to his or her parent as they will not constitute interest

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[38] See, generally, Blattmachr & Boyle, INCOME TAXATION OF ESTATES AND TRUSTS (Practising Law Institute 17^{th} Ed.), Chapter 8.

[39] Perhaps, a beneficiary would welcome the opportunity to make the election if it will reduce overall income taxes even if the beneficiary is not guaranteed to receive trust payments. It seems the trust could provide for a particular individual to be a trust beneficiary only if she makes the election and provide that she would cease to be a beneficiary if she seeks to revoke it.

[40] Reg.1.1361-1(j)(8).

[41] It does not seem that an S corporation, to be respected as such, need be formed for a business purpose. See Rev. Rul. 75-188, 1975-1 C.B. 276.

[42] See, e.g., section 409(b) of the Uniform Fiduciary Income and Principal Act.

or dividends for purposes of the Kiddie Tax), which may well be at a lower rate than if they were taxed to a non-grantor trust.[43]

Although it seems contrary to the official position of the Internal Revenue Service and the Treasury Department that the assets in a grantor (or deemed owner) trust are treated as owned for income tax purposes by trust's deemed owner, the IRS has ruled that the payment of the FAI to a grantor trust with respect to the QSST beneficiary will cause the trust to lose its QSST status. PLR 9014008 ("We… conclude that if the income of any trust is distributed to a grantor trust rather than to the individual beneficiary himself, then the trust will no longer be a QSST") (not precedent). That seems somewhat strange not only because to be a good QSST, the beneficiary must elect to be treated as the deemed owner of the S corporation income under Section 678 (a grantor trust provision), but also because any shareholder which is a grantor (or deemed owner) trust as to a US income taxpayer is, under Section 1361(c)(2), an eligible S shareholder. The PLR may simply reflect the view that all FAI must be distributed directly to the individual beneficiary of any QSST and not merely have it attributed for income tax purposes to the beneficiary. Maybe that position does not really matter. Under Section 1361(c)(2), a trust that is a grantor trust with respect to a US individual taxpayer is a permitted shareholder of an S corporation. So logically, even though the trust might not be considered a QSST, the corporation should maintain its S corporation status, as long as the trust is a deemed owner trust under Section 678.

Suppose an individual were the shareholder of an S corporation which was made the beneficiary of a Plan. Would that arrangement be treated as though the individual were the Plan beneficiary for payout purposes? As discussed above, because the IRS has held a decades long and official position that an individual who is the deemed owner of a trust (such as one described under Section 678) owns the assets of the trust for income tax purposes, it seems the individual deemed owner should be treated as the Plan beneficiary. However, unlike the treatment of a deemed owner of a grantor or Section 678 trust, the shareholder of an S corporation, while having the income of the corporation made his or her income, there are limitations and special rules[44], which prevent the shareholder from viewed as the owner of the assets of the corporation. Accordingly, just having Plan distributions included in the gross income of an individual does not seem sufficient to cause that taxpayer to be treated as the Plan beneficiary. Indeed, it seems even more uncertain a beneficiary of a QSST to be treated as being the Plan beneficiary when the S corporation is named as that beneficiary. Hence, in planning, one probably should assume that the five-year payout rule will apply if an S corporation is made the Plan beneficiary. However, making an S corporation with a QSST shareholder as the Plan beneficiary may, in some cases, be preferable to naming Accumulation Trust where the ten-year pay rule will apply.

[43] Note that income earned in an S corporation that is taxed to its shareholders retains its tax character pursuant to Section 1366(b), so Plan Distributions will not be treated as interest or dividends and will fall under the exemption from the net investment income tax under Section 1411, foreclosing the ability for the parents to treat the income as their own.

[44] See, e.g., 1366(d) and (f).

Can Using a QSST Be Beneficial If the Five-Year Rule Applies?

The answer to that question depends upon several factors (or variables) such as the amount involved, rates of return and the tax rates applicable to the income. For example, assume $1,000,000 is in a Plan and it grows at one percent (1%) a year to $1,051,010 in five years without current taxation. If it is then distributed to a single individual taxpayer and subject to a 33.4% income tax, $699,972 will be netted.[45] If that amount then grows at 1% a year, but subject to an annual assumed effective 20% tax[46] (so the annual growth is .8%), it will grow in five years to $728,422. On the other hand, if the $1,000,000 Plan grows at 1% untaxed for ten years, it will grow to $1,104,622. If it is then subject to a 37% tax, it will net $695,912 to the Plan beneficiary. So, postponing the tax for ten years instead of only five year was not beneficial, depending on the applicable tax rates after distribution, and it is even less beneficial if the growth is taxed from year five to year ten at an effective tax rate less than 20% as it would be if the beneficiary has no other taxable income, all other things being equal.

The outcome will not necessarily be the same (that is, postponing the tax to year ten may be beneficial) if the rate of return is higher. For example, $1,000,000 in a Plan will grow at five percent (5%) a year to $1,276,282 in five years without current taxation. If it is then distributed to a single individual taxpayer and subject to a federal income tax of approximately 34%, $842,346 will be netted. If it then grows at 5% a year, but is subject to an annual 8% tax, as it would be (approximately) if the beneficiary has no other income (so the annual after-tax growth is approximately 4.6%), it will grow in another five years to $1,054,766. If the $1,000,000 Plan grows at five percent (5%) a year and is untaxed for ten years, it will grow to $1,628,895 but if it is then subject to a trust rate of approximately 37%, it will net $1,026,203, less than the net amount that would be available even if the proceeds were distributed within five year and thereafter taxed to a single individual taxpayer.

On the other hand, if the net Plan proceeds after being taxed to an individual following a five year deferral then grow at 5% a year, but are subject to an annual tax of 20% (so the annual after-tax growth is 4%), the proceeds will grow in another five years to only $976,510 (that is, in year ten), which is less than $1,026,203 that would be available if, after a ten year deferral, the Plan proceeds were distributed to a trust. So, postponing the tax to year ten instead of only to year five in that case was beneficial. The point being that it is not only the years of deferral that matter, it also matters at what rate the income on the Plan proceeds will be taxed after leaving the Plan.

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[45] The calculations of income tax were run for a single individual taxpayer, who did not itemize deductions, assuming no other income, and is not subject to state income taxes, using the Federal Tax Calculator available at https://smartasset.com/taxes/income-taxes.

[46] If the one percent return were the individual taxpayer's only income, no federal income tax would be due (unless the Kiddie Tax applied).

If the Plan is smaller, the postponement to year ten will be less beneficial all other things being equal. The opposite will be true if the Plan is large. Postponement also likely will be beneficial if the beneficiary is in a high income tax bracket. It is not so likely if the beneficiary is only taxed on the Plan distributions. In other words, the lower the income tax rate on the net amount of Plan proceeds, the less beneficial postponement of taxation will be. [47]

Potentially, the best of all possible worlds is for the Plan proceeds to be paid to a QSST so that the Plan proceeds are taxed to the QSST beneficiary, but are accumulated inside the S corporation, thereby also receiving several of the benefits of trusts (such as freedom from claims of creditors).[48]

Funding the Income Tax Liability of a QSST or Section 678 Beneficiary

If the S corporation's income is attributed to the QSST beneficiary, he or she presumably will need cash to pay the income taxes on the S corporation income attributed to him or her pursuant to the QSST election.[49] Having the S corporation pay a dividend to the QSST which, in turn, is paid to the beneficiary (as it must be if it is FAI, as it probably would be[50]) means the beneficiary may have more income and resources so as to cause possible disqualification for government benefits and, perhaps, otherwise make the dividends subject to creditor claims. However, the trustee of the QSST, rather than distributing the S corporation distribution to the beneficiary, could instead apply it in satisfaction of the beneficiary's income tax obligation. According to PLR 8907010 (not precedent) that should be treated as being a payment to the beneficiary, as a QSST is required to do. Yet, that discretionary payment by the QSST of the beneficiary's income tax liability will not count as income or as a resource for at least most governmental benefit programs.[51]

Therefore, the S corporation can pay a dividend to the QSST in the amount of the beneficiary's income tax liability (which will be based at least on the S corporation's income imputed to the QSST beneficiary), and the trust can pay the income tax liability of the beneficiary and will be treated as distributing that amount (which may be FAI) to the beneficiary so the status as a QSST will not be lost and the risk of causing the beneficiary to lose governmental benefits will not arise.[52]

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[47] There are a number of ways to reduce the effective income tax rate. Probably the most common is to postpone the sale of appreciated assets. Another is to acquire life insurance because, as a general rule, income earned "inside" a life insurance policy is not currently and may never be taxed. See Lipkind & Blattmachr, "Income Tax Aspects of Variable Life Insurance Policies," 125 J of Taxn 52, (February 2015).

[48] The beneficiary of the QSST probably should not have the power to control distributions from the corporation as her creditors might argue that such a power means all the corporate assets should be treated as belonging to the beneficiary.

[49] The beneficiary must affirmatively elect for the trust to be a QSST and may revoke the election only with the consent of the Commissioner of Internal Revenue. Reg. 1.1361-1(j)(11).

[50] Section 409(b) of the Uniform Fiduciary Income and Principal Act.

[51] SSA – POMS: SI 00815,400 available at .https://secure.ssa.gov/apps10/poms.nsf/lnx/0500815400.

[52] An alternative to using a QSST is to use an electing small business trust defined in Section 641(c) which is an eligible S shareholder, under which all of the S corporation's income is taxed to the trust at the highest federal

The trustee of a Section 678 trust could be authorized to pay the beneficiary's income tax liability (limited, if otherwise appropriate, to the tax on the income imputed to the beneficiary from the S corporation). If the trust is discretionary and spendthrift, this authorization likely will not make the trust, at least in most states, subject to the claims of the creditors of the beneficiary.[53] Nor is the payment to the tax authorities likely to be attachable by other creditors of the beneficiary.[54]

Should a QSST Be Considered for an EDB?

If the person whom the Plan Holder wishes to benefit is an EDB, then using an S corporation and a QSST may not be beneficial, if the Plan proceeds would otherwise be received by a trust but taxed at the rates applicable to the trust beneficiary because a Conduit Trust is used. That may be the case if naming the S corporation will require that that all Plan distributions must be paid within five years, as discussed above. Because that almost certainly would be adverse, a QSST probably should not be used for an EDB without a ruling or clarification from the IRS that the EDB will be treated as receiving the Plan distributions.

Of course, for a surviving spouse, rolling the Plan into the spouse's own IRA may be the most efficient tax step to take although it would give the spouse complete access to the amount in the IRA. A Conduit Trust for the spouse may be a better choice if there is concern about the spouse having unlimited access to the Plan itself. A Conduit Trust will allow a relative long "stretch" although not be quite as long as if the spouse did roll it all over to his or her own IRA.

For a minor child EDB, the stretch may not be much longer than 10 years using anything but a direct beneficiary designation or a Conduit Trust. Almost certainly, overall federal income taxes will be lower if Plan proceeds are taxed to the minor child over the limited (until majority is reached) life expectancy of the minor plus ten years, all other things being equal. But they may not be equal, such as where the Plan Holder does not want the minor child to receive the Plan proceeds so they are made payable to an Accumulation Trust and taxed at the compressed rates and paid out under the ten-year rule and not the special rule for minor children of the Plan Holder. In such a case, perhaps making an S corporation, with a QSST shareholder, the Plan beneficiary may make some sense.[55]

Some Comparisons: Running the Numbers

Suppose the annual Plan distributions will be $12,000 each year. If the QSST beneficiary has no other income (as she might not if she were disabled), she would enjoy a $12,000 standard

income tax rate and without the ability to shift the income to a trust beneficiary. However, that may provide a way to avoid state income tax.

[53] See, e.g., New York EPTL 7-3.1(d).

[54] There may be a special state law to provide this protection, as in Alaska. See discussion in Blattmachr, Chapman, Gans & Shaftel, "New Alaska Law Will Enhance Nationwide Estate Planning-Part 1, 40 Estate Planning 3 (Sept. 2013).

[55] "A *minor's* consent is *made* by the *minor*, *legal representative* of the *minor*, or a natural or adoptive parent of the *minor*…." available at https://www.google.com/search?tbm=bks&hl=en&q=who+is+a+minor%27s+legal+representative+for+making+a+QSST+election

deduction and no income tax would be due (assuming the Kiddie Tax did not apply). If instead, the $12,000 were taxed to a trust for a DB, about $3,000 of income taxes would be payable. Now that comparison is incomplete assuming, as likely will be the case, the entire amount in the Plan may have to be distributed within the fifth year following the death of the Plan Holder. Even though the Plan distributions would be more bunched together if payable to an S corporation than if they were paid over the life expectancy of an individual beneficiary or over a ten-year payment period, they likely would be taxed at lower rates than if paid and taxed to a trust. Another factor is that, as long as Plan distributions are not made, the Plan will continue to grow income tax free. A further complication arises if the beneficiary is subject to state income tax when payments to a trust may be structured to avoid state income tax.

Suppose further that the Plan at the death of the Plan Holder has a balance of $1.2 million and is withdrawn in equal payments each year for six years[56] under the five-year regime at $200,000 a year,[57] putting aside income and growth. If the Plan distributions are taxable to an unmarried beneficiary (directly or through a QSST) who has no other income, the beneficiary will owe about $41,048 each year in income tax for a total tax bill of approximately $246,288. That is about a 21% erosion of the Plan proceeds from taxes. Assume, alternatively, that the payments are taken ratably over 24 years ($50,000 annually) by an Accumulation Trust for a Disabled EDB. That trust will owe about $16,821 each year in income taxes or $403,776 total income taxes. That is almost a 34% erosion. Nevertheless, that comparison is incomplete. It does not take into account, among other things, that, if the Plan Distributions are made over an EDB's lifetime or for ten years rather than five years, earnings inside the plan or IRA will continue to grow for a longer time income tax free. Of course, that assumes there will be growth inside the Plan, which may not occur. Furthermore, it is a political certainty that the income tax laws, including rates, will change which will directly and indirectly affect Plans and their distributions.

However, one may create an excel spreadsheet to run some comparisons using assumed rates of taxation, growth within and outside the plan, and taking Plan distributions over a number of years or at one time (probably the last year under either the five-year or ten-year payout regimes.) A key factor is determining the relative benefit of keeping assets inside the Plan to grow tax free compared to the benefit of spreading Plan distributions over time to reduce the effective rate of income tax. Of course, the need for Plan proceeds for lifestyle or other reasons may compel a beneficiary to take Plan distributions even if that is not the most tax efficient strategy.

What About a C Corporation or a CRT as Beneficiary?

A so-called C corporation also could be the Plan beneficiary. A C corporation is subject to income tax at only a 21% rate. That almost certainly will be below the rates a trust would face

[56] See note 13 for an explanation of why there are six calendar years in which Plan distributions may be made under the five-year rule.
[57] As mentioned above, if the beneficiary of the plan or IRA is not an individual or a see-through trust, the entire Plan must be distributed not later than the end of the fifth calendar year following the calendar year of the Plan Holder's death or, in other words, over six years. The Plan Distributions can be taken ratably over that six-year period or delayed in total until the end of that sixth calendar year.

(except on very small distributions). But the five-year distribution rule will apply. Moreover, when the accumulated Plan Distributions, after the 21% corporate tax, are distributed as a dividend, they will be subject to income tax probably, under today's law, as long-term capital gain.[58] If that rate is 23.8%, the total tax rate would be 39.8% [21% + (23/8% x 79%)]. But the real effective rate does not take into account the ability to postpone the taxation of the Plan proceeds. Of course, the C corporation could accumulate and not distribute the Plan proceeds, but it is possible that it would face the personal holding company tax under Section 541 or the accumulated earning tax under Section 531. Neither of those apparently applies to an S corporation.

A charitable remainder trust (CRT) defined in Section 664 can receive Plan proceeds entirely free of income tax because the trust is income tax exempt. Although it is beyond the scope of this article to discuss the matter in any significant detail, an income only with make-up CRT is, perhaps, the best way to postpone the taxation of interests in a Plan. A detailed article about that was published in the May 2020 issue of this magazine.[59]

Summary and Conclusions

The loss of the so-called stretch option for Plan distributions likely means more immediate and possibly higher taxation of Plan proceeds. Those beneficiaries who are EDBs may continue to enjoy longer term payments which will allow more tax-free growth of amounts in a Plan and reduce distributions which may result in an overall reduced effective tax rate than if Plan distributions were bunched into a shorter number of years. A surviving spouse of the Plan Holder also may continue to enjoy stretch benefits, as well as a delay in the obligation to commence taking distribution. A minor child of the Plan Holder enjoys "stretch" payments only until reaching majority, following which the ten-year payout period must begin. A "not more than ten years younger" EDB may get a few extra years of "stretch" payments but likely, in most cases, not significantly more than under the ten-year payout rule. Disabled or Chronically Ill EDBs can enjoy the same stretch as under prior law. However, if the distributions are made to them directly, they may lose government benefits if the distributions cause them to exceed income or resource levels for those benefits Also, just to complicate things, they may have to be paid to a guardian (or other fiduciary), if the EDB is incompetent.[60] Hence, an Accumulation Trust for such EDBs should be. Although the Plan distributions received by the Accumulation Trust will likely be taxed at very high rates, avoiding state income tax may be a significant offsetting factor.

Making Plan distributions payable to an S corporation which has a QSST as its shareholder may be appropriate to consider for some beneficiaries, even if the five-year payout period must be

[58] See IRS Publication 550 for the meaning of qualified dividend (which is taxed as long-term capital gain under Section 1). *Cf.* Reg. § 1.312-6(b).
[59] Blattmachr, Blattmachr & Fox, "Using a Charitable Remainder Trust as the Recipient of a Qualified Plan or IRA," 46 Estate Planning 3 (May 2020).
[60] Note that the commissioners of uniform laws rejected making custodian accounts maintained under the Uniform Transfer to Minors Act spendthrift. In any case, any spendthrift protection provided by such an account presumably would lose all protection when the minor reaches majority and the entire account must be distributed to her.

used (which seems likely although, perhaps, not certain). The Plan distributions will be income of the S corporation but included in the gross income of the beneficiary who may be in much lower tax brackets than a trust. Distributions of the Plan proceeds need not be made from the S corporation to the QSST. The QSST need not make any distribution to its beneficiary (other than FAI) and the trustee may pay the income tax liability of the beneficiary without disqualifying the trust as a QSST and without causing the beneficiary to lose qualification for certain governmental benefits.

A so-called Section 678 Trust or BDIT may be best of all from an income tax perspective but it raises certain creditor and governmental benefit issues which the QSST may not.

Comparing the numbers is appropriate but over a ten-year period, taxation will change, perhaps radically, making it very challenging to determine what is the best strategy to use.

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