(Theme: Tax Law)

Title:
Michigan Discretionary Asset Protection Trusts and Qualified Plan or IRA Accounts

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Fast Facts:

If a discretionary trust satisfies the nine special design features described in this article, payments from a qualified account paid to the trust will "flow through" the trust and be taxable to the beneficiary using the "life expectancy" method.

Discretionary trusts that fail to identify the "measuring life" persons expose qualified accounts to a 50 percent excise tax under Code Section 4974.

Trusts that do not address the use of special definitions of "income" as to funds received from a qualified account expose such payments to income tax at the higher trust income brackets.

On April 1, 2010, the Michigan legislature codified the "discretionary trust."[1] The trustee may be given discretion to determine which beneficiary of the trust receives income or principal payments or both. Under a discretionary trust, neither a trust beneficiary, a transferee of a trust beneficiary, nor a creditor of a trust beneficiary has a right to any amount of income or principal. Principal or income may be distributed only in the exercise of the trustee's discretion.[2] This is different from a generic spendthrift provision. It is a statutory directive under the Michigan Trust Code. When properly utilized, the discretionary trust can keep a beneficiary's creditors at bay.

The trust can be used to preserve life expectancy payments when distributions from a qualified plan account or individual retirement account (IRA) are payable to the discretionary trust. This article refers to both qualified plan accounts and IRAs as qualified accounts. Preserving life expectancy treatment for qualified account payments takes careful drafting. The trust must incorporate various rules under the Michigan Trust Code, the Michigan Uniform Principal and Income Act[3] (the Act), and federal tax rules.

The Act provides that terms of the trust have control over the default provisions of the Act.[4] Unless the Act is overridden, 100 percent of each payment from a qualified account will be taxed at the high income tax brackets applicable to trusts and 90 percent of minimum distributions will be taxable to the trust.[5] The drafter must carefully address federal statutory provisions while dealing with these requirements under the Act. Federal law found in various sections of the Internal Revenue Code (the Code) and the Treasury regulations under the Code are key. The Code permits the trust to use different definitions of income as long as these definitions are consistent within each category of administration. There are six categories of trust administration that can employ definitions of income:

(1) Funds leaving the qualified account and paid to the discretionary trust can be defined as "income" employing Code Sections 691(a)(1) and 691(a)(3).[6]

(2) Assets held by the trust, independent of qualified accounts, include "income interest," "rental income," and "dividend income" as defined under the Act.[7]

(3) Code Section 2056(b)(5) or 2056(b)(7) and their Treasury regulations, notices, and announcements must include income for the marital trust to qualify for the federal estate tax marital tax deduction.[8]

(4) Proper funding of the so-called "exempt trust" that arises under Code Section 2642(a) having a generation-skipping tax inclusion ratio of zero has separate rules defining income. A Generation-Skipping Transfer Tax (GSTT) exempt trust must follow the rules in Treasury Regulation 26.2642-2(b).[9]

(5) Proper funding of a marital trust by a pecuniary amount requires a pro-rata share of income.[10]

(6) Divisions of trust shares upon the death of a trust beneficiary must track the separate share accounting rules.[11]

For the first two categories, these types of income can be distributed at the discretion of the trustee to one or more of the current trust beneficiaries. The income in the first category pertaining to qualified accounts is "income in respect of a decedent" (IRD).[12] This is measured at the date of death of the grantor.[13] Until all IRD is paid from the qualified account, the discretionary trust must direct that the IRD definition applies to such payments. Code Section 691(a)(3) requires the character of the IRD payment to have the same character it would have had if the decedent had lived and received the payment. This includes payments from a traditional qualified account or a Roth qualified account.[14]

With respect to categories (1) and (6) above, the character of a distribution from a qualified account or a Roth qualified account flows to the recipient as distributable net income (DNI) under Code Section 691(a)(1) and must be separately accounted for under Code Sections 663(c) and 691(a)(3). These Code sections allow the categories of income to become part of a trust's DNI. Properly using the definition and directing the trustee to distribute IRD amounts from the qualified account payment to one or more of the trust beneficiaries avoids taxation at the higher income tax rates applicable to trusts. There is strong historical support for this tax position.

Treasury Regulation 1.643(b)-1 provides that trust provisions that "depart fundamentally from traditional principles of income and principal will generally not be recognized."[15] Treasury regulations under Code Section 643 do not provide an example involving IRD and its relationship to DNI. However, other Code sections and Treasury regulations clearly support the position that using the IRD definition does not "depart fundamentally" from state law.

The strongest support for IRD to be treated as DNI is found in the context of a qualified domestic trust (QDOT) as defined in Treasury Regulation 20.2056A-1(a)(1)(i). Congress and the Treasury made an effort to limit the use of trusts involving QDOT marital deductions when IRD is being paid in a post-death setting to the QDOT. Their goal in the QDOT setting is to collect federal estate taxes that are attributable to IRD accruals when a QDOT is the recipient of IRD. Treasury Regulation 20.2056A-5(c)(2) controls how the definition of income must apply when IRD is paid to a QDOT. It overrides Code Section 643 for IRD to be defined by a trust as being part of DNI, stating that "income has the same meaning as is provided in section 643(b), except…income does not include any other item that would be allocated to corpus under applicable local law governing the administration of trusts *irrespective of any specific trust provision* to the contrary… *[f]urther,…income does not include* items constituting income in respect of a decedent (IRD) under section 691."[16] Without this override directive, the QDOT regulations otherwise exempt QDOT payments of IRD income from federal estate tax under Code Section 2056A(b).[17]

Moving the focus from income, the discretionary trust must also be designed to satisfy the life expectancy rules. These rules pertain to using the life expectancy of the "person with the shortest life expectancy," which means the oldest person in the group of beneficiaries who may receive qualified account payments through the trust.[18] This permits the retention of the qualified account tax-free environment over the period of the shortest life expectancy, hereafter referred to as the "measuring life." The person with the shortest measuring life must be an individual identifiable at the grantor's date of death and as of September 30 of the year following the grantor's date of death.[19] These rules also require that the trust must be irrevocable.[20] The trust must provide that the trustee's discretion does not empower the trustee to eliminate all members of the measuring life group of persons from payments of income and principal from the qualified account. The trust must provide that no portion of the qualified account payments can be used to pay the grantor's state or federal estate/inheritance taxes or estate settlement expenses. The trust must prohibit any allocation to a beneficiary not classified as an individual until after all trust shares have vested.[21]

The discretionary trust should also limit the general power of appointment used under Code Section 2041 to avoid payment of the GSTT.[22]

Discretionary trusts that fail to identify the measuring life persons expose qualified accounts to a 50 percent excise tax and the inability to utilize "life expectancy" qualified account distributions.[23] Trusts that do not address the use of special definitions of income as to funds received from a qualified account expose such payments to income tax at the high trust income brackets. Trusts that fail to address separate definitions of income for marital deduction purposes expose the grantor's estate to a loss of the federal estate tax marital tax deduction. Trusts that fail to account for the directive to properly fund exempt trusts expose the trust to GSTT. The trust must separately account for IRD. Drafters must design the discretionary trust with these rules in mind to eliminate such exposures.

Below are nine separate special design features developed for a discretionary trust that will permit payments from a qualified account payable to the discretionary trust to flow through the trust and be taxable to the beneficiary. Because the discretionary trust qualifies as a designated beneficiary, the portion of the qualified account payable to the trust may utilize the life expectancy payment method. The nine features are:

(1) The discretionary trust must define the amounts distributed to it from a qualified account as IRD until the IRD is exhausted; then the trust can revert to the traditional definition of income or a unitrust definition. The drafter should use direct references to Code Sections 691(a)(1) and 691(a)(3) to define the character of each income payment. As noted previously, regulations issued in the context of the QDOT rules tell us that the IRD payments enter into DNI and are taxable to the trust beneficiary and are not taxable to the trust. This does not "depart fundamentally" from state law.[24] This design also must accommodate marital deduction and GST goals.

(2) No money from the qualified account can be used to pay the grantor's state or federal estate/inheritance taxes or estate settlement expenses. A directive should also appear in the last will and testament and coordinate with the trust document. For these and other purposes, the trustee must treat the qualified account payments as separate from all other assets.[25]

(3) The discretionary trust need not and should not accumulate post-death qualified account payments within the trust.[26] A prohibition for qualified account payments to be accumulated in the trust assures that the measuring lives are at all times identifiable.

(4) The trust must be irrevocable during the period from the grantor's date of death until October 1 of the year following the death of the grantor. No portion of the qualified account should vest in any beneficiary until on or after the October 1 date. Treasury Regulation 1.401(a)(9)-4, A-5(b)(2) indicates the conditions for identification of the designated beneficiary. Further, in a discretionary trust, no vesting should take place until all beneficiaries of the trust are 100 percent vested.[27]

(5) The qualified account may not be physically divided into separate shares for separate measuring lives purposes.[28] Because of this prohibition, Code Section 408 (the rollover rule) may not permit a qualified account payable to the trust to be rolled over into a new IRA account established by the trust beneficiary after all accounts are fully vested. The discretionary trust can have special features that arise as to a fully vested trust share. This can encompass the

discretionary right of the trustee to allow for the continuation of the holding of the trust share. It can also provide that, when all trust shares are fully vested, the beneficiary may identify contingent beneficiaries to take his or her share at the time of his or her death. The share can continue within the trust. The discretionary trust should contain provisions permitting the trustee to assess fees and handle investments and allow for payouts of the share.

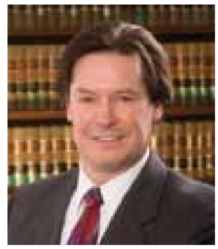
(6) The discretionary trust must provide that the accrued but unpaid portion of a required minimum distribution that has not been paid to the trust before the death of any trust beneficiary must be paid to the next person among the identifiable beneficiaries.[29] Example 2(ii) of Treasury Regulation 1.401(a)(9)-5, A-7(c) requires that the trust cannot ignore a successor beneficiary. When the last person left in the group of measuring life persons dies, the Treasury regulation implies that the unpaid, accrued required minimum distribution must be paid to the estate of that last person.

(7) The discretionary trust cannot forfeit any share of the qualified account if there is only one remaining beneficiary. This is the so-called last-one-standing rule. Under this rule, the sole remaining measuring life beneficiary has full vested rights. Discretionary payments cease and payments must be made to the sole remaining trust beneficiary.[30] This rule applies even when a trustee would like to direct a forfeiture to occur, for example, when there is a question of the entitlement of a beneficiary to a "means-tested" benefit such as Medicaid.

(8) The discretionary trust should override the "prudent investor rule" under the Michigan Trust Code. This allows the trustee to retain the qualified account assets as a separate qualified account payable to the trust. The trust instrument should also fully indemnify the trustee because the trustee does not control the investment of the qualified account. Some qualified accounts do not allow for any trustee direction of investments and some allow limited choices among stated investments dictated by the qualified account sponsor.

(9) The discretionary trust should specifically provide a general power of appointment to defeat the application of the GSTT, but limit the general power so it may only be exercised in favor of individuals who are younger than the oldest measuring life person as first determined by the trust upon the death of the grantor, as limited by Treasury Regulation 1.401(a)(9)-4 and 1.401(a)(9)-5. This individual could be a creditor. The scope of this power should be sufficiently broad to encompass the requirements of Code Section 2041 as to a general power of appointment.[31]

In summary, the discretionary trust can creditor-protect the qualified account in a post-death setting. It can allow for life expectancy treatment for qualified account payments. It can allow for qualified account payments classified as IRD to be taxable to the beneficiary receiving the payment. The trust can properly fund marital shares and exempt trust shares from the application of the GST. The trust can permit a general power of appointment to protect against the GST when a trust beneficiary dies and the trust share is part of a non-exempt trust. Finally, the new design features can protect the income deferral of a qualified account. ■



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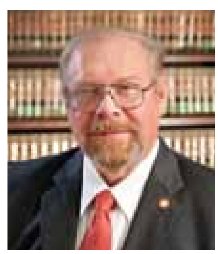

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FOOTNOTES

1. See MCL 700.7101 *et seq.*
2. See MCL 700.7103(d); MCL 700.7505; MCL 700.7815.
3. MCL 555.501 *et seq.*
4. MCL 555.503(1)(a).
5. MCL 555.809(3).
6. 26 USC 691(a)(1); 26 USC 691(a)(3).
7. See MCL 555.502; MCL 555.805; MCL 555.809(2).
8. 26 USC 2056(b)(5); 26 USC 2056(b)(7).
9. See 26 CFR § 26.2642-2(b).
10. 26 CFR § 20.2056(b)-5(f).
11. 26 CFR § 1.663(c)-2.
12. See 26 USC 691.
13. 26 USC 691(a)(1).
14. See generally 26 USC 691(a)(3).
15. 26 CFR § 1.643(b)-1.
16. 26 CFR § 20.2056A-5(c)(2) (emphasis added).

17. Final QDOT regulations provide a formula determination of principal as to each IRD payment, applying rules under 26 CFR § 20.2056A-4(c). IRD is viewed historically as a permitted design feature for a trustee to direct that a qualified account payment is to be allocated to a trust beneficiary. This definition should not be viewed to "depart fundamentally" from state law. The regulations under 26 CFR § 1.643(a)-1 through § 1.643(a)-7 do not provide for an example that involves IRD as income. The cited QDOT regulation clearly references the need to override the design feature referenced in 26 CFR § 1.643(a)-1 and 26 CFR § 1.643(b) as a definition employed in the trust design that may encompass IRD as being part of DNI.
18. 26 USC 401(a)(9)(B)(iii).
19. 26 CFR § 1.401(a)(9)-4, A-1 and A-4(a).
20. *Id.* at A-5(b)(2).
21. See 26 CFR § 1.401(a)(9)-4 through § 1.401(a)(9)-9.
22. Under 26 USC 2041(b)(1), a general power of appointment is a power exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate. If a decedent can exercise the power in favor of any one of the four categories, he holds a general power. *Edelman v Comm'r,* 38 TC 972, 977 (1962). The language that can be used in a discretionary trust design encompassing a qualified account should designate the power to a creditor who is an "individual" person younger than the oldest measuring life person under the trust, as determined independent of the general power of appointment. As such, the limitation of the discretionary trust and the limitation as to who might receive the qualified account portions under a discretionary trust that is not otherwise exempt under 26 USC 2611 and 26 USC 2642(a) from the application of the GSTT is a general power of appointment that defeats the GSTT. This occurs as the presence of the power causes the assets subject to the power of appointment to be included for federal estate tax purposes in the estate of the power holder. This design of the general power for GSTT purposes also allows the discretionary trust to satisfy the rules articulated in Treasury Regulation 1.401(a)(9)-4A1, which require that at all times the measuring lives of persons who may be allocated an interest in a qualified account are identifiable. Finally, GSTT Regulations 26.2642-2(b)(2) and (3) apply an "appropriate interest" that "fairly reflects" appreciation and depreciation. See 26 CFR § 26.2642(b)(2) and (3). Here, the discretionary trust design must take into account these rules to assure the exempt GSTT trust enjoys a GSTT inclusion ratio of zero.
23. 26 USC 4974(a).
24. See 26 CFR § 1.643(b)-1.
25. Regulation 1.401(a)(9)-4 asserts that an estate may not be designated as beneficiary. 26 CFR § 1.401(a)(9)-4, A-3. A trust that takes on the role of an estate and pays taxes falls into this same category unless the trust and the last will and testament of the qualified account owner prohibit the use of any proceeds from the qualified account and the qualified account itself from this payment obligation. In addition, there must be other assets, independent of the qualified account as to its portion that is payable to the trust, to satisfy, in full, these expenses and taxes. To avoid confusion, tax payment clauses in wills must be very specific. See *Green v Finney,* 233 Mich App 525; 593 NW2d 190 (1999) (resolving issues that arose when little care was taken to determine whether the estate was to pay the death tax or the decedent's trust was to pay the death tax). Treasury Regulation 1.401(a)(9)-4, A-4 requires that "the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the employee's death" are the beneficiaries that are to be identified as measuring life beneficiaries to allow an IRA account or qualified plan account sponsor to provide payments utilizing the Treasury Regulation 1.401(a)(9)-9 life expectancy tables.
26. See generally 26 CFR § 1.401(A)(9)-5, Example 2(ii).
27. 26 CFR § 1.401(a)(9)-4, A-5(c).
28. *Id.*
29. 26 CFR § 1.401(a)(9)-5, A-7(c).
30. 26 CFR § 1.401(a)(9)-5, A-7.
31. See generally 26 USC 2041.