RMDs and the UPIA

Alert: This missive is complicated, but important when an IRA is paid to an irrevocable.

Take-Away: Life gets complicated for a trustee that takes required minimum distributions (RMDs) from an IRA. That trustee must then apply the Revised Uniform Principal and Income Act (RUPIA) to those distributions that the trustee receives. The trustee must also allocate the IRA's internal income when it accounts to the trust beneficiary.

Background: Michigan trustees, as a rule, must follow the Revised Uniform Principal and Income Act (RUPIA.) [MCL 700.7817(u).] Michigan has adopted the RUPIA, last amended in 2012. [PA 302 of 2012.] [MCL 555.501-555.1006.] When an IRA is paid to an irrevocable trust, if the trust instrument does not provide otherwise, the trustee must follow the RUPIA when it receives the required minimum distribution (RMD), which can lead to surprising calculations. An example will demonstrate some of the challenges and calculations involved when accounting for a required minimum distribution (RMD) under the RUPIA.

Example: Archie died on July 4, 2024, at age 76. Archie was survived by his widow Edith, age 62, and one daughter, Gloria. Archie and Edith owned their home jointly. Only Archie worked during the marriage, so only Archie had an IRA at the time of his death. Archie has a 'reduce to zero' marital deduction trust, which became irrevocable at the time of Archie's death. Only the credit shelter trust will be funded on Archie's death with his IRA. Archie's IRA has a balance of about $1.0 million. Archie's trust provides that Edith is entitled to the net income, and she has the right to request discretionary distributions of trust principal for her lifetime, for her health, support, and maintenance. On Edith's subsequent death, the trust terminates, and the IRA payments will continue to Gloria. If Gloria fails to survive her mother, the trust terminates and distributes its assets to Anti-defamation League. An independent trust company is named as trustee since Archie is convinced that Edith is a dingbat. The trust's first accounting period ends on December 31, 2024. Archie's trust earned income between his death and December 31, 2024, for which the trust company must account and determine the RMD and then follow the RUPIA. Assume that Archie's RMD for the year is around $40,000.

Distribution Rules: The beneficiaries of Archie's Trust are Edith and Gloria. Under the new rules, more likely than not that the Anti-defamation League will be a disregarded trust beneficiary when applying the see-through rules for Archie's trust. While Edith could qualify as an eligible designated beneficiary if she had been named the sole beneficiary of Archie's IRA, Archie's trust is the named beneficiary of his IRA, not Edith. The trust probably fits within the definition of an accumulation see-through trust, since under the trust instrument's terms, the trust company is authorized to retain, or accumulate, IRA distributions. This means then that Edith is the oldest beneficiary of the credit shelter trust, and the IRA must be distributed, in full, by the 10th year after Archie's death. [IRC 401(a)(9).] Edith, as the oldest trust beneficiary, sets the life expectancy factor to calculate the RMD.

Trust Accounting Rules: Shortly into January 2025 the trust company must account to Edith for the annual RMD along with the IRA's receipts and expenses. This means that the trust company must allocate the RMD between income and principal. Sadly, Archie's trust instrument is silent on this detail, which means that the trust company must turn to Michigan's 'default' rule for allocations between principal and income. Archie's trust did not qualify for the marital deduction. As such, the trust must use the arbitrary allocation method set forth in Michigan' UPIA to allocate the 2024 RMD. That statute provides that RMDs constitute 90% principal and 10% income. The amount of the IRA's internal income is irrelevant even if it exceeds the 10% allocation. [MCL 555.809(3).] Since Archie's RMD for 2024 was $40,000, the trust company will allocate $4,000 to trust income and $36,000 to trust principal. Edith is probably not happy with this allocation!

Short Diversion: A more recent version of the RUPIA, which came out in 2018, the Uniform Fiduciary Income and Principal Act (UFIPA), has been adopted by only a handful of states. It drops the arbitrary 90%-10% allocation method and uses a new rule, "income of the IRA is income of the trust approach", as part of that Act. The states that have adopted this newer version of allocation of RMDs are Arkansas, California, Colorado, Florida, Kansas, Utah, Virginia, and Washington. If this change were adopted in Michigan, Edith would, more likely than not, receive a much larger amount of the RMD each year as her right to receive 'net income.'

Internal Income: The internal income generated by Archie's IRA payable to the trust must also be accounted for by the trust company and it, too, must be allocated between income and principal. This internal income is defined in the RUPIA as a 'separate fund.' [MCL 555.809(6).] The statute directs that trust company "shall determine the internal income of each separate fund for the accounting period as if the separate fund were a trust subject to this act." There are two methods under Michigan's RUPIA to determine the IRA's internal income. One approach is to treat the IRA as a trust and apply traditional fiduciary accounting rules, the 'basic rule.' The other approach is to apply a fixed percentage, 3.5%, to the IRA's beginning balance but only if the trustee is unable to determine the separate fund's, i.e., IRA's, internal income.

Example: The RMD for the trust accounting period starting on January 1 is $70,000 and is withdrawn on January 20. On that date, the IRA's internal income is $1,000 based on the receipt of the income for the accounting period beginning on January 1, following the basic method. If the trust company withdraws that amount on January 20, following the basic RUPIA method, the allocation of $70,000 RMD breaks down: $1,000 to trust income, the IRAs internal income as of the payment date (January 20), and the balance of $69,000 is allocated to trust principal. If the second, percentage method was used, and the RMD was $70,000 for the year, $35,000 is allocated to the IRA's internal income and the balance, $35,000 is allocated to principal during the trust's accounting period.

Shortfall: The trust company may also face a related issue if the account's payments do not include all the internal income and Edith is entitled to all current net income from the trust. In this situation the trust company must transfer principal to income equal to the amount of internal income that exceeds the total of the payments from the IRA, something akin to a 'power to adjust.'

Practical Observation: These allocation rules are admittedly hard to follow. The terms of the trust instrument can, however, control the determination of the IRA's internal income and its allocation. For example, the trust instrument could direct that all IRA distributions received by the trustee be treated as net income to be distributed in total to the trust's income beneficiary.

Or the trust instrument can be tailored to override Michigan's default allocation rules when dealing with the IRA's internal income. The use of the fixed percentage method can produce more IRA internal income than following the traditional fiduciary accounting rule, but that would arguably benefit the current income beneficiary of the trust to the detriment of the remainder beneficiaries. An example of an 'RUPIA override' trust provision might look something like the following:

- *The trustee shall withdraw the annual required minimum distribution (RMD) in equal monthly payments, allocate to trust income an amount, meaning the IRA's internal income, equal to 4% of the IRA's fair market value on the date immediately preceding the beginning this Trust's accounting period and distribute it monthly to my surviving spouse. The balance of the RMD following allocation of the IRA's income shall be allocated to trust principal. If the income exceeds the RMD, the trustee shall withdraw the difference and allocate it to trust income.*

Conclusion: Naming a trust as the beneficiary of an IRA results in several computations, starting with determining the payment period (i.e., does the trust qualify as a 'see-through' trust), then determining the required minimum distribution (RMD) amount for the year, and then following the RUPIA 90%-10% allocation, and finally allocating the IRA's internal income when distributions are made from the trust. Best to add a provision to the trust, if it is expected to receive a large IRA, to specifically address the trustee's allocation responsibilities and try to avoid some of the default provisions of the RUPIA.

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