Naming a Trust as the IRA Beneficiary

Reasons to Name a Trust (Advantages)

Control and management of post-death IRA distributions to beneficiaries.
Preservation of a large IRA or Roth IRA – to ensure the stretch IRA.
Asset and creditor protection – use irrevocable trust.
Divorce protection – second marriages.
Beneficiary is a minor, disabled, incapacitated, spendthrift, unsophisticated and possibly vulnerable to financial predators.
To secure funds for payment of estate taxes.
To fund charitable bequests – charitable remainder trusts.
To secure state estate tax exemption.
To secure the generation skipping transfer tax exemption – it is not portable (like the estate and gift tax exemptions are).

Reasons Not to Name a Trust (Disadvantages)

Complexity – many tax rules to follow.
Costly to create and maintain – annual tax returns and administration.
High trust tax rates for trust income retained in discretionary trusts.
- For 2015, trusts hit the top 39.6% rate after $12,300 of taxable income.

No separate account rules – required minimum distributions based on shortest life expectancy (if all trust beneficiaries are individuals).

Types of IRA Trusts
Conduit vs. Discretionary Trust

Common Features of Both Conduit and Discretionary Trusts:

Must distribute annual required minimum distributions (RMDs) from the inherited IRA to the trust.

Can qualify as see-through trusts if they meet the requirements – if they don't, there is no stretch IRA.

Depending on the trust terms, distributions to trust beneficiaries can exceed the RMD, for example, for health, education, maintenance, support, etc.

Qualifying as a See-Through Trust

IRA trusts should qualify as "See-through" or "Look-through" trusts.

Benefits of See-Through IRA Trusts:

Allows the oldest of the individual trust beneficiaries to be treated as if he or she were named directly. The inherited IRA can be stretched over that person's life expectancy.

If the trust does not qualify as a see-through trust, then the IRA will be treated as if there was no designated beneficiary and the post-death payout will not be based on a beneficiary's life expectancy. It will be based on the rules that apply when there is no designated beneficiary for an IRA.

To qualify as what the IRS refers to as a **"see-through"** or **"look-through"** trust for IRA distribution purposes, the trust must meet the following requirements outlined in IRS Regulation Section 1.401(a)(9)-4, A-5:

1. The trust is valid under state law.

2. The trust is irrevocable or it becomes irrevocable upon death.

3. The beneficiaries of the trust are identifiable.

4. The required trust documentation has been provided by the trustee of the trust to the IRA custodian (or plan administrator for a company plan) no later than October 31st of the year following the year of the IRA owner's death.

In addition to the above requirements, ***all trust beneficiaries must be individuals*** or there will be no designated beneficiary on the IRA and the stretch option will be lost.

If any one of the trust beneficiaries is not a person (for example, an estate or charity), then the IRA may not have a designated beneficiary and the stretch could be lost.

Conduit or Discretionary Trust?

The answer will depend on how much post-death control the client wants the trustee to have over the IRA distributions paid to the trust, and ultimately to the beneficiaries of the trust. A discretionary trust provides the most post-death control.

Conduit Trust

Post-death annual RMDs flow through the trust to the trust beneficiaries – no IRA funds are retained in the trust. This eliminates any income tax at trust tax rates.

Post-death annual RMDs are based on the age of the oldest trust beneficiary but only primary beneficiaries are counted; remainder beneficiaries are not considered.

Discretionary (Accumulation) Trust

Trustee has discretion – Trustee does ***not*** have to pay out all IRA distributions to the trust beneficiaries. The trustee is given discretion to either pay out some, all, or none of the IRA distributions to the trust beneficiaries.

Distributions from the inherited IRA to the trust that are not paid out to the beneficiaries of the trust (retained by the trust) will be subject to income tax at trust tax rates. Distributions from inherited Roth IRAs will generally be tax free.

Post-death RMDs are based on the age of the ***oldest*** of ***ALL*** trust beneficiaries (both primary and remainder trust beneficiaries). If any of the trust beneficiaries are not individuals (an estate or charity for example), then the trust fails to qualify as a see-through trust and distributions are based on rules that apply when there is no designated beneficiary.

IRA Trust Planning Points

Check to see that the trust is actually named as the IRA beneficiary on the IRA beneficiary form.

Review IRA beneficiary forms to see if a naming a trust as the IRA beneficiary is still appropriate. Situations change with life events.

Check to see if the trust will qualify as a see-through trust. All trust beneficiaries must be individuals.

A testamentary trust (a trust created under the will) is ok as long as this trust is specifically named as the IRA beneficiary – do not name the estate or “as per my will” as IRA beneficiary to get the funds to the testamentary trust.

Check to see if the IRA custodial agreement (or plan document, for a company plan) will accept a trust as the beneficiary.

When you name a trust as the beneficiary of the IRA, you have only one IRA beneficiary – the trust. There is no separate account treatment when a trust is the IRA beneficiary. The trust’s beneficiaries cannot each use their own age for RMDs as they can if named directly and the inherited IRA is timely split. Separate trusts would be needed for each beneficiary to accomplish this.

Avoid trust provisions that require payment of estate debts and expenses. That could cause the trust to fail as a see-through trust since the estate can be considered one of the trust beneficiaries. Trust administration expenses are ok.

Avoid using the term “income” in an IRA trust. That could trigger the use of the Uniform Principal and Income Act resulting in potential payout problems for trust beneficiaries, unless the trust is a QTIP trust.

If naming a trust as the IRA beneficiary, use a separate, stand alone, irrevocable trust. The trust should inherit the IRA, and only the IRA. Don’t mix non-IRA assets and IRAs in the same trust, if at all possible.

Who will be the trustee? Do they know what to do after death? Do they know which professionals to hire to help them? Does the trustee know the client’s wishes as to the level of discretion for payouts to beneficiaries?

Trust termination - when will the trust end?

Will the trust be assignable to beneficiaries?

Should the trust have a spendthrift clause to protect trust assets?

Explain the taxation of payouts from the inherited IRA – to avoid post-death surprises.

Post-Death Trust Implementation ⚠ Do Not Move the IRA Into the Trust!

Post-Death IRA Trust Administration
Set up properly-titled inherited IRA: “John Smith, IRA Deceased 11-15-14, f/b/o, John Smith Family Trust, beneficiary”.

IRA assets inherited by a trust beneficiary cannot be rolled over. They must be moved as a trustee-to-trustee transfer only. Any check payable to the trust is a taxable distribution.

Only required minimum distributions (RMDs) are required to go from the inherited IRA to the trust annually – these distributions are taxable (unless there is basis or it’s a qualified distribution from a Roth IRA). Distributions are taxed to the ultimate recipient; the trust or the beneficiaries of the trust, depending on the terms of the trust.

If conduit trust – The RMD passes to the trust’s beneficiaries and they pay the tax at their own tax rates.

If discretionary trust – If distributions from the inherited IRA to the trust are retained in the trust (not passed out to the trust’s beneficiaries), the trust pays the tax at trust tax rates. Distributions paid from the trust to the beneficiaries are taxable to the beneficiaries at their own income tax rates.