What About Trusts as IRA Beneficiaries?

Even though there are no tax benefits, there may be circumstances when you want to name a trust as your IRA beneficiary. Trusts, however, create unique problems and tax complications even when executed perfectly. IRA trusts cannot provide the answers for tax and personal solutions that many IRA owners are looking for. And quite often trusts are poorly drafted and cause more problems than they are worth.

IRA owners can name trusts as beneficiaries as a way to better control post-death distributions and restrict access for beneficiaries who might otherwise squander large inherited IRAs. Alternatively, adult beneficiaries may need help with managing the IRA funds and taking required distributions. They simply may lack the necessary financial acumen to handle larger sums.

The other reason to name a trust as beneficiary is not to restrict the beneficiary, but to insure that the IRA funds are protected from creditors and bankruptcy. Since the trust assets are not actually owned by your beneficiary, if your beneficiary is pursued by creditors or succumbs to bankruptcy, the trust assets are protected.

Instead of naming a person (for example a child or grandchild) as a direct beneficiary on the account, a trust would be named. The trust beneficiary would be the child, grandchild, or other person that the IRA owner wants to receive the IRA.

Or suppose that you want to control the ultimate disposition of his IRA. In a typical second marriage situation (or even with some first marriages), you may want to leave your spouse the annual IRA income, but after survivor's death you wants to make sure that the IRA goes to your children and not to those from the spouse's first marriage.

A trust can be used to hold money for estate taxes if there is a risk that the IRA beneficiary will take the money and run without paying his share of the estate tax. When an individual is a direct beneficiary of an IRA, the entire IRA goes to that person at death. There is usually a clause in the will called the "tax apportionment clause" which spells out who is responsible for the estate tax, both on items that pass through the will and on property that passes outside the will, such as an IRA or life insurance. But even if the will's tax clause states that the IRA beneficiary must pay his or her share of the estate tax from the IRA proceeds, it may be too late if the beneficiary has already fled with the newly inherited funds. A trust could escrow a portion of the IRA for estate taxes. This would not apply to a nontaxable estate, where assets are under the limits shown in the Appendix.

The beauty of trusts is that you bring another party into the equation, the trustee, to act on behalf of the beneficiary. The trustee should be a trusted family member or advisor that will make sound business decisions on behalf of the beneficiary.

If the trust is appropriate, it must qualify under the various IRS rules in order for the trust beneficiaries to be able to use their own life expectancies for calculating post-death required distributions. If the trust does not qualify, the stretch IRA option is lost to the ultimate beneficiaries.

The requirements for a trust to qualify as a designated beneficiary are: *(1)*

• The trust must be a valid trust under state law.

• The trust must be irrevocable at death.

• The beneficiaries of the trust must be identifiable.

• A copy of the trust document must be provided to the plan by October 31 of the year following the year of the IRA owner’s death.

• The beneficiaries of the trust must be individuals.

• No person may have the power to change the beneficiaries after December 31 of the year after the participant’s death.

If these requirements are met, then the trust qualifies as a designated beneficiary, and the trust beneficiary’s life expectancy can be used to calculate post-death required minimum distributions. If the trust fails to qualify, then there is no designated beneficiary and trust beneficiaries will not be able to stretch post-death required distributions over their life expectancies. In that case, the IRA will be paid out either under the 5-year rule (if the IRA owner dies before his Required Beginning Date) or over the remaining life expectancy of the deceased IRA owner (if the IRA owner dies after his RBD).

The arguments against using a trust are as follows:

• It’s one more complication.

• It’s an additional tax return to be filed.

If there are multiple beneficiaries, they must all use the life expectancy of the beneficiary who is oldest (if you have three children close in age, it does not have much impact on their respective stretch periods. However, if the beneficiaries have large differences in age, you should use a trust for each).

(1) Life and Death Planning for Retirement Benefits, Fourth Edition, Natalie Choate