



Trusts as IRA Beneficiaries – Are They Compatible?

For working Americans, their IRA may be one of their largest assets. It is also one of the most complicated and tax sensitive assets to own for estate planning and wealth transfer purposes. However, with careful planning and consideration of appropriate beneficiary designations, IRAs can be effectively protected for the next generation.

The use of trusts is a common means of transferring wealth to heirs while still providing a level of protection from creditors and preserving future value for beneficiaries. However, when the primary asset to be transferred is an IRA, special considerations apply.

It is critical that a client's advisors work together in designing and implementing a strategy for utilizing trusts as IRA beneficiaries. This planning involves careful drafting by an attorney familiar with the rules along with consultation with the client's CPA. The trustee and custodian of the IRA is also a key member of the planning team since they will be charged with the actual implementation of the distributions to the trust.

Before diving into the complexities of using trusts as beneficiaries, it is important to understand the basics of IRA distributions during life and after the death of the participant.



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General IRA Distribution Rules during the Participant's Life

IRS regulations require that IRA owners (also known as participants) must begin making withdrawals from their IRA upon attaining age 70-1/2 (known as the required beginning date or RBD). Distributions may begin as early as age 59-1/2 without incurring early distribution penalties. Since distributions are subject to ordinary income tax rates, most individuals who can afford to do so will defer withdrawals as long as possible to defer the income tax consequences.

Minimum required distributions must be withdrawn over the life expectancy of the participant. These required distributions are calculated using uniform life expectancy tables created by the IRS.

Death of the Participant

When considering the transfer of an IRA, it is important to understand the distribution rules that come into play upon the death of the participant. These rules depend upon whether the participant had reached age 70-1/2 and who was named as beneficiary of the account.

Designated Beneficiary

In order to take distributions over a beneficiary's life expectancy, the beneficiary must be a Designated Beneficiary. The Internal Revenue Code defines a Designated Beneficiary as "any individual designated as a beneficiary by the employee. The participant's estate is not considered a designated beneficiary. A charity is also not considered a designated beneficiary. A trust must meet certain requirements in order to be considered a designated beneficiary.

Absent a Designated Beneficiary, IRA accounts must be distributed within five years of the participant's death.

Death before Required Beginning Date

If a participant dies before the required beginning date, the distribution rules depend upon the beneficiary of the IRA. A surviving spouse is permitted to treat the inherited IRA as his or her own and take distributions based upon his or her life expectancy. If the designated beneficiary is an individual other than the surviving spouse, the individual may make withdrawals over his or her life expectancy. If there is no designated beneficiary, the entire balance of the IRA must be withdrawn within 5 years of the participant's death.

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A participant is entitled to designate multiple beneficiaries. Required distributions to these beneficiaries will be based upon the life expectancy of the oldest beneficiary unless a special separate accounts rule can be met. The separate accounts rule provides that each beneficiary may utilize their own life expectancy for determining required distributions if a separate account is established for each of them by the end of the year after the year of the participant's death.

Death after Required Beginning Date

If a participant dies after the required beginning date and has not taken the required minimum distribution, it must be taken by the end of the year by the beneficiary of the IRA. The amount of the distribution is whatever the participant would have been required to withdraw had he or she survived.

If the surviving spouse is the beneficiary, the remaining balance of the IRA must be withdrawn over the longer of the life expectancy of the surviving spouse or that of the deceased participant had he or she survived. For individuals other than the surviving spouse, the withdrawal period is the longer of the beneficiary's life expectancy or the remaining life expectancy of the deceased participant.

The period for multiple beneficiaries is the longer of the participant's remaining life expectancy or that of the oldest beneficiary. The separate accounts rule mentioned above may also apply in cases of death after the required beginning date.

IMPORTANT NOTES AND DISCLOSURES

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Trusts as Designated Beneficiaries

A trust is not an individual but can be a Designated Beneficiary if certain rules are met which allow the underlying individual beneficiaries of the trust to be considered the Designated Beneficiary in lieu of the trust. The requirements which must be met for a trust to qualify as a Designated Beneficiary are:

1. The trust must be valid under state law.
2. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the participant.
3. The beneficiaries of the trust must be identifiable from the trust document.
4. Certain documentation must be provided to the plan administrator of the IRA by October 31 of the year after the participant's death.

Requirements 1, 2 and 4 can be met fairly easily. However, requirement 3 can cause a myriad of tax problems depending upon who the beneficiaries are and how they are identified.

Identifying Trust Beneficiaries

The regulations do not require that a trust beneficiary be specified by name. Therefore it is acceptable to have a group of beneficiaries who are members of a class (such as children or grandchildren) as long as the specific individuals can be identified as of September 30 of the year following the participant's death. This individual beneficiary identification is key because the oldest of these beneficiaries is the one whose life expectancy will determine the period over which the IRA will be paid to the trust.

There are very complex rules surrounding which beneficiaries must be counted for this purpose. In the case of a trust with a single beneficiary, the determination of life expectancy is simple. However, many trusts have multiple beneficiaries. The rules surrounding the identification of multiple beneficiaries depends upon the type of trust involved.

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Conduit Trusts

A conduit trust is one in which the trustee is required to immediately distribute all IRA distributions directly to the income beneficiary of the trust. This sole income beneficiary's life expectancy will govern the required distribution amounts. Remainder beneficiaries are ignored for purposes of determining the life expectancy to be used. If there are multiple income beneficiaries, the oldest beneficiary's life expectancy is to be used and all IRA distributions must be distributed to one or more of the income beneficiaries.

The requirements for conduit trusts really defeat the purpose of having a trust because the trustee has no ability to accumulate the IRA distributions. Thus, assets are not able to be invested and preserved for the future.

Accumulation Trusts

An accumulation trust is one in which the trustee may accumulate IRA distributions inside the trust for future distribution to one or more beneficiaries. Since multiple beneficiaries have the potential to receive the IRA distributions, all potential beneficiaries of the trust must be considered in determining who has the shortest life expectancy which will determine the distribution period.

Trust Income Tax Treatment of IRA Distributions

IRA distributions are considered taxable income and as such are taxed to the trust. The maximum tax rate for trusts is 39.6% and is reached with only \$12,400 in taxable income. However, if the trust distributes any portion of its income, that income is taxed directly to the beneficiary of the trust. Since much more taxable income is needed to reach the maximum individual tax rates, it is better for the trust to distribute the income to the beneficiary. However, as stated before, this generally defeats the purpose of a trust.

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Trusts with Charitable Beneficiaries

As discussed above, a charity is not considered a Designated Beneficiary for purposes of the IRA distribution rules. Therefore, any trust which has a charity as a potential beneficiary will be required to take all distributions from the IRA within five years of the participant's death.

A charitable remainder trust is a viable alternative when it is desired to provide an annuity stream to a non-charitable beneficiary for their lifetime or a period of years with the remainder to a charity. The required distributions will be paid to the trust over the five year period. However, the trust itself pays no income tax. Rather, taxable income is tracked within the trust and is taxed to the non-charitable beneficiary only as distributions are made to that beneficiary.

The Conundrum

Based on the above discussion of the rules and regulations, the use of a trust as the beneficiary of an IRA may not be ideal. The easiest solution is to leave other assets in trust and use the IRA for outright gifts to beneficiaries and charities. However, that is not always an option.

If it is necessary to leave IRA assets in trust, it is absolutely essential to consult with your team of advisors who are well-versed in these rules. The beneficiary trust must be carefully constructed and drafted to avoid the pitfalls that can occur. It will be necessary to balance the benefits of protecting assets with the potentially onerous and costly income tax consequences.

Contact us if you have questions or would like assistance with determining the best means of transferring IRA assets to your heirs. This paper is intended to be educational in nature and does not replace the need for analysis of individual circumstances. ■

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