WHITE PAPER

Trusts as IRA Beneficiaries

Planning Issues Post SECURE Act

BY **KIM GARCIA**, PRINCIPAL & DIRECTOR OF CLIENT EXPERIENCE

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, especially after the enactment of the SECURE Act in 2019.

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.

continued on next page ›

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.

General IRA Distribution Rules during the Participant's Life

Internal Revenue Service ("IRS") regulations require that IRA owners (also known as participants) must begin making withdrawals from their IRA upon attaining age 72 (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Minimum required distributions must be withdrawn over the life expectancy of the participant.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. These life expectancy tables were changed pursuant to new IRS regulations in 2020 to be effective for distributions beginning in 2022. These new tables reflect longer life expectancies and therefore will reduce the amount required to be withdrawn on an annual basis.

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 72 and who was named as beneficiary of the account.

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 IRA does not have a Designated Beneficiary as defined below, the entire balance of the participant's IRA must be withdrawn within 5 years of the date of death.

Designated Beneficiary

In order to take distributions over a longer period, 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.

continued on next page ›

The distribution rules depend upon the beneficiary of the IRA. The general rule after the SECURE Act is that the distributions must be withdrawn by the end of the 10th year following the participant's date of death. There is no requirement that the distributions be taken on a pro-rata basis over this time period. They must simply be fully withdrawn by the end of the 10-year period. This 10-year period replaces the life expectancy of the beneficiary which was the rule prior to enactment of the SECURE Act.

There are 5 categories of beneficiaries who may still take distributions based upon life expectancy. These beneficiaries are as follows:

- 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. Additionally, the spouse (or a conduit trust for his or her benefit) is not required to begin taking RMDs until the end of the year in which the deceased participant would have reached age 72.
- A minor child of the participant may take distributions over his or her life expectancy until they reach the age of majority at which time the remaining payments must be paid within 10 years. The age of majority is that defined by state law. The regulations do state that a child shall continue to be treated as a minor until the earlier of age 26 or the completion of a specified course of education.
- A disabled beneficiary may receive distributions over his or her life expectancy. The beneficiary must be disabled as of the date of the participant's death. Upon the beneficiary's death, the 10-year rule applies for any future beneficiary.
- A chronically ill beneficiary may also utilize his or her life expectancy for making withdrawals but must be chronically ill at the time of the participant's death. Upon the beneficiary's death, the 10-year rule applies for any future beneficiary.
- The life expectancy payout will also apply to a beneficiary who is less than 10 years younger than the participant. Upon the beneficiary's death, the 10-year rule applies for any future beneficiary.

continued on next page ›

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 in allowing the trust to qualify as a designated beneficiary and therefore eligible for the 10-year rule.

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 is simple. However, many trusts have multiple beneficiaries. The rules surrounding the identification of multiple beneficiaries depends upon the type of trust involved.

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. All distributions from the IRA must be made within the 10-year period after the participant's death. If there are multiple income beneficiaries, all IRA distributions must be distributed to one or more of the income beneficiaries within the same 10-year period.

continued on next page ›

The requirements for conduit trusts really defeat the purpose of having a trust because the trustee has no ability to accumulate the IRA distributions. Conduit trusts are particularly onerous in this post Secure Act era since everything would be required to be distributed to the beneficiary within 10 years.

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. The total distribution of the IRA must still be completed within 10 years of the participant's death.

Minor or Disabled Beneficiaries

If any beneficiary of a trust meets the definition of a minor or disabled beneficiary, it would be advisable to create separate trusts for these beneficiaries to take maximum advantage of their respective life expectancies.

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 in 2021 is 37% and is reached with only $12,950 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.

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.

continued on next page ›

Important Notes And Disclosures

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.

Another option is to convert a traditional IRA into a Roth IRA and avoid taxability of the distributions to the trust and beneficiaries. However, this requires careful analysis as the participant will be required to pay the income tax on the IRA upon conversion.

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.

DIVERSIFIED TRUST

ATLANTA

400 Galleria Parkway, Suite 1400
Atlanta, GA 30339
Phone: 770.226.5333

GREENSBORO

701 Green Valley Road, Suite 300
Greensboro, NC 27408
Phone: 336.217.0151

MEMPHIS

6075 Poplar Avenue, Suite 850
Memphis, TN 38119
Phone: 901.761.7979

NASHVILLE

3102 West End Avenue, Suite 600
Nashville, TN 37203
Phone: 615.386.7302