

NAMING A TRUST AS BENEFICIARY OF AN IRA

By

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Your client instructs you to draft a trust to receive his \$1 million individual retirement arrangement (IRA) at his death to benefit his two grandchildren, now ages 27 and 10. The task seems simple enough. After all, practitioners routinely name trusts as beneficiaries of IRAs to assist in minimizing estate taxes, protecting beneficiaries, and forcing a beneficial stretch of IRA distributions. You know, though, that use of your standard testamentary trust, with its normal accumulation and trustee-discretion terms, could be disastrous under the minimum distribution rules. The client, and ultimately the beneficiaries, will expect assurance that:

- The trust will result in a “look through” to the individual beneficiaries so that distributions of IRA benefits can be stretched over life expectancies rather than forced out more quickly and with crushing tax consequences.
- The IRA will remain as an IRA after the client’s death, rather than pay to the trust in a lump sum. That way, income taxes due on that IRA remain deferred, with those tax amounts building greater wealth within the IRA over the years of the trust.
- The IRA will divide into separate IRA accounts so that one-half the IRA will pay out over the life expectancy of the 27-year-old (56.2 years) and the other one-half will pay out over the even longer life expectancy of the 10-year-old (72.8 years). Separate accounts allow the younger beneficiary to benefit from the 16 additional years of tax deferral and IRA growth.
- No contingent beneficiary with a shorter life expectancy will be considered in determining life expectancy payouts.

Accomplishing these four goals is necessary for the financial success of the trust but difficult given the current narrow position of the IRS regarding trusts as beneficiaries of retirement accounts. Final regulations issued in 2002 greatly simplified the formerly

oppressive minimum distribution rules relating to retirement plans in all areas except one - - trusts.¹ The 2002 regulations substantially complicated the use of trusts for distributing benefits over the trust beneficiary's life expectancy. Moreover, 2003 presented shocking private letter rulings, which held that trust beneficiaries could not use the separate accounts rule to determine favorable individual distribution periods. These adversities make it challenging to create a trust for an IRA, necessitating that the practitioner take special steps not applicable in ordinary trust situations.

Special Step #1 - - Assure All Trust Beneficiaries Are Individuals

The minimum required distribution (MRD) rules in the final regulations require that a designated beneficiary be an individual; and trusts are not individuals.² In proper cases, though, the IRS has allowed a "look-through" from the trust to its beneficiaries, treating each beneficiary as named directly by an IRA owner. This look-through allows the IRA benefits to be paid over the beneficiary's life expectancy, rather than the IRA paying out to the trust at a faster rate.

An example illustrates the importance of life expectancy payout. An IRA owner dies at age 69, with a \$500,000 IRA. If an estate, charity, or other non-individual is beneficiary of the IRA, the five-year rule will require a complete distribution of the IRA no later than December 31 of the fifth year following the year of the IRA owner's death.³ Roughly \$400,000 in deferred federal and state income taxes must be paid on the IRA distributions, and any potential stretch of tax-deferred benefits over a life expectancy is lost.

If, instead, the IRA owner designates his 35-year-old child as IRA beneficiary (either outright or through a proper look-through trust), distributions from that IRA can

be stretched over the 48.5-year life expectancy of the child. Stretching distributions from the IRA over the child's life expectancy (assuming growth of 8%) yields total distributions to the child of over \$5 million. This beneficial stretching of distributions over an individual life expectancy becomes the key to the success of an IRA.

To qualify as a look-through trust under the final regulations, a trust must meet four requirements:

1. The trust must be valid under state law.
2. The trust must be irrevocable or become irrevocable when the IRA owner dies.
3. The trust beneficiaries must be identifiable from the trust instrument.
4. Proper documentation must be provided to the IRA custodian.⁴

Requirement 3 is the troublemaker. Identifiable beneficiaries must be actual, living individuals. The IRS is adamant that if an estate, charity or other non-individual is included in the mix of trust beneficiaries, the trust will not qualify for look-through.⁵ The problem commonly arises when the trust provides that the trustee may pay trust assets to the decedent's estate to cover debts, administration expenses, or death taxes. The inclusion of these non-individual beneficiaries causes the trust to fail to qualify for look-through status.⁶ This drafting error can be avoided simply by adding a sentence to the trust to state that no retirement benefits will be used for this purpose.

In some cases, though, the IRA funds may be needed to cover expenses. The 2002 regulations provide a "shake" period that can be used to resolve certain issues regarding beneficiaries.⁷ After an IRA owner's death, we have until September 30 of the year following the year of that death to cash-out or eliminate improper beneficiaries.⁸

So, a trust that provides for payments to non-individuals also could include a restriction preventing the trustee from making such payments after the September 30 deadline. This effectively should eliminate the non-individual beneficiaries from consideration.

Special Step #2 - - Assure the IRA Remains an IRA

IRA benefits must remain in the IRA following the death of the owner for continued tax deferral and accompanying growth. If the trust instrument, the IRA beneficiary designation form, or the IRA agreement requires the IRA to be distributed to the trustee shortly following the owner's death, income taxes due on the entire IRA will be payable by the trust in the year of receipt of those proceeds. The benefits of life expectancy payout are lost forever.

Assuring that the IRA is distributed to the trustee over the extended life expectancy of an individual trust beneficiary requires several considerations:

- The IRA agreement must permit life expectancy distributions to a beneficiary. If it does not, the IRA account should be moved to a satisfactory provider by way of a direct rollover.⁹
- The IRA owner must complete a beneficiary designation form that specifically designates a living individual or a proper "look-through" trust as beneficiary (see Special Step #1, above).
- Upon the IRA owner's death, the IRA must remain in the owner's name. Non-spouse beneficiaries, including the trustee of a trust, cannot transfer inherited accounts without triggering immediate taxation of the entire account.¹⁰
- The trustee must take the first MRD from the IRA by the end of the year following the year of the owner's death to avoid the 50% penalty.¹¹ Ideally, this MRD will be based on the single life expectancy of the trust beneficiary.
- Sadly for those with 401(k) plans, 403(b) plans or other such qualified plans, most do not allow trusts of any sort to receive distributions over a life expectancy. Instead, the trust must receive the entire plan balance

shortly after the owner's death, resulting in the immediate imposition of all income taxes. In contrast, IRAs offer flexibility to create stretch when left to a proper look-through trust.

Unlike IRAs, qualified plans are subject to federal law, which requires the participant to name the spouse as beneficiary unless the spouse signs a waiver.¹² Consequently, use of trusts for benefits in second marriages is almost impossible. If the spouse does sign the waiver, the plan benefits still are paid to the trust in full immediately after the death of the participant, with the trust paying the income taxes on the funds at the trust's highest tax rate.

Special Step #3 - - Arrange for Separate Accounts Treatment

Under normal circumstances, if an IRA owner names a group of individuals (children, grandchildren) to receive retirement benefits, the life expectancy of the oldest of the group is used for distributions to the entire group.¹³ If some of the beneficiaries are much younger, this use of the older beneficiary's life expectancy imposes swifter distributions from the IRA.

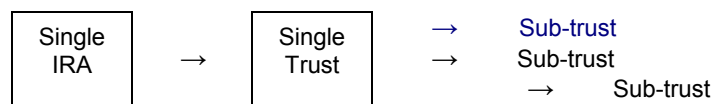
Example: Joe leaves his \$1 million IRA in trust to benefit his sister (age 60) and his son (age 30). The IRA is distributed over the sister's 25.2-year life expectancy rather than the son's 53.3-year life expectancy.

The final rules allow an exception where separate accounts are created.¹⁴ Using the above example, Joe could separate his single \$1 million IRA into two \$500,000 IRAs before he dies, with one IRA designating the trust for his sister as beneficiary and the other the trust for his son. Then, at Joe's death, each separate IRA will pay out to each trust over the named beneficiary's single life expectancy. The son gains 28 years of additional tax deferral and growth because of the separation.

Some owners do not want the hassle of managing separate IRAs or accounts and would rather have one IRA that separates upon the owner's death. For separate accounts after the owner's death, the IRA beneficiary designation form itself must provide for the separation, using either fractional (1/3 1/3 1/3) or percentage (50% & 50%) interests.¹⁵ A pecuniary bequest (\$10,000) does not fall within the definition for separate account treatment.

Additionally, the separation into separate accounts must occur by the end of the year following the year of death.¹⁶ However, the safest rule is to separate by September 30th of the year following death because life expectancy payouts are determined by that date.¹⁷

The real complication occurs where the owner of a single IRA names as beneficiary a single trust that splits into separate trusts at the owner's death.



The diagram above reflects the arrangement addressed by the IRS in three letter rulings in 2003.¹⁸ In those rulings, the IRA owner listed a revocable trust as beneficiary of a single IRA. Both the trust and the beneficiary designation form authorized the trustee to create a separate trust for each of the three individual trust beneficiaries. Following the owner's death, the trustee divided the IRA into separate IRA accounts, one for each of the trust beneficiaries, and also divided the trust into three sub-trusts.

The IRS ruled that the division of the IRA into three separate IRAs was valid, as was the creation of three sub-trusts following the owner's death. However, the sub-trusts would not qualify for the separate account treatment for pay-out purposes.

Accordingly, the life expectancy of the oldest beneficiary would be used as a measuring life for all three separate accounts.

Based on these and similar rulings,¹⁹ we are left with the following options when we want an IRA to benefit multiple trust beneficiaries who are not close in age:

- Divide the single IRA into separate IRA accounts during the owner's life, with each account designating a separate trust beneficiary; or
- Create separate trusts during the owner's life, with one trust for each beneficiary. The IRA form still must provide for separate shares.

Special Step #4 - - Caution Regarding a Remainder Beneficiary

Generally, a trust will name contingent or remainder beneficiaries to take if primary beneficiaries fail to survive. Before the 2002 final regulations, practitioners believed these contingent trust beneficiaries could be ignored for MRD purposes. For example, if a typical minor's trust terminated when the child beneficiary reached an age well within the child's life expectancy, say age 30, and the child received all the trust assets, we thought we could ignore a much older contingent beneficiary.

Private Letter Ruling 2002-28025 shocked all of us. In this PLR, a grandmother set up a trust for her 5-and 6-year old grandsons, leaving a large IRA. The trust was the typical accumulation trust, and the trustee had the power to accumulate IRA distributions inside the trust and pay them out to the beneficiaries in the trustee's discretion. Once the grandchildren reached age 30, the trust assets would be distributed to them in full. The grandmother added her 67-year-old brother as a contingent beneficiary to receive the IRA benefits if both children died before age 30 - - a rather remote possibility.

In the PLR, the IRS stated that the ages of all trust beneficiaries, including the contingent beneficiary, will be considered in determining what life expectancy to use for payouts. Because the trustee had the discretion to accumulate MRDs, the contingent beneficiary conceivably could receive some of those distributions if the grandchildren died. Consequently, the 67-year-old's life expectancy of 19.4 years drove the distributions to the trust rather than the 76.7-year life expectancy of the older of the two grandchildren, resulting in a probable loss of millions in tax deferred growth.

In trust drafting, practitioners commonly employ accumulation trusts that allow a trustee to accumulate trust income inside the trust for beneficiaries. For example, the trustee is given the discretion to make distributions for health, education, maintenance and support and then accumulate any extra income, adding it to trust principal.

For a trust that receives IRA benefits, though, the accumulation provision should be eliminated. If the trust does not allow for accumulation of minimum distributions, then contingent beneficiaries can be disregarded. Such a trust, commonly called a conduit trust, would require that all distributions from the IRA be paid out to the beneficiary each year. MRDs are not accumulated. Where there is no possibility of accumulation of MRDs, the contingent beneficiary is ignored.

In the alternative, the trust could include only contingent beneficiaries who are younger than the primary trust beneficiaries. That way, consideration of their life expectancies will not decrease the payout period.

CONCLUSION

The IRS unnecessarily has complicated the rules surrounding the use of trusts for IRAs. Practitioners are forced to exercise extreme caution in this complex area until the IRS simplifies and makes more practical its rules for determining trust beneficiaries and their distributions.

¹ Reg. §1.401(a)(9)-1 *et seq.*

² IRC §401(a)(9)(E).

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Reg. §1.401(a)(9)-3, A-1.

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Reg. §1.401(a)(9)-4, A-5 and A-6.

⁵ Reg. §1.401(a)(9)-4, A-3. This is so even though the IRA may pass from the estate to an identifiable individual. PLR 2003-43030.

⁶ Reg. §1.401(a)(9)-4, A-3; Reg. §1.401(a)(9)-8, A-11.

⁷ Reg. §1.401(a)(9)-4, A-4(a).

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Id.

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The IRS has recognized the right of IRA beneficiaries to move the IRA after the owner's death. See e.g. PLR 2003-49009; PLR 2003-43030.

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IRC §408(d)(3)(C).

¹¹ Reg. §1.401(a)(9)-3, A-1; Reg. §54.4974-2.

¹²

Retirement Equity Act of 1984; IRC §401(a)(11) and §417; ERISA §205.

¹³

Reg. §1.401(a)(9)-4, A-1; LTR 2002-09057.

¹⁴ Reg. §1.401(a)(9)-8, A-2. A separate account is an account that contains a portion of the owner's IRA benefits, including a pro-rata share of investment gains and losses, and contributions and forfeitures.

¹⁵ Reg. §1.401(a)(9)-8, A-3; PLR 2003-07095. If separate shares are created in the trust document, but not in the beneficiary form, separate share treatment will not be allowed. This is so even if the trust terminates and splits into separate shares for multiple beneficiaries immediately at the owner's death.

¹⁶ Reg. §1.401(a)(9)-8, A-2(a)(2); PLR 2002-28025; PLR 2002-35038; PLR 2002-35041.

¹⁷ Reg. §1.401(a)(9)-4, A-4.

¹⁸ PLR 2003-17041; PLR 2003-17043; PLR 2003-17044.

¹⁹ See also PLR 2003-17043.