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RETIREMENT PERSPECTIVES

More Tips on Trusts for IRA and 401(k) Holders

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Brian Dobbis, QKA, QPA, QPFC, TGPC
Director, Retirement Solutions

Here's the nitty-gritty on naming a trust beneficiary, plus insights on trust mechanics and taxation, and why bequeathing a Roth IRA appeals to many investors.

(Second of a two-part series)

Owners of a 401(k) plan or IRA account, depending on their estate and legacy-planning goals, have the option to name a trust as a beneficiary instead of an individual (e.g., spouse, child, grandchild, etc.).

In **last week's column**, I covered the strict, complicated, and cumbersome IRS rules to be followed so that the oldest trust beneficiary can use his/her own life expectancy to determine post-death payouts, including the requirement that the trust qualify as a "look-through." So long as the trust qualifies, the "stretch" technique (whereby payments can be "stretched" out over a period of time) can be utilized.

In this week's column, I will discuss reasons to name a trust beneficiary, trust mechanics, trust taxation, and why leaving a Roth IRA appeals to many investors.

If you choose to name a trust as the beneficiary of a retirement account, such as an IRA or 401(k), there are number of considerations. Notably, a retirement account that is left to a trust must follow the IRA distribution rules just as any other living, breathing beneficiary. There are many rules determining the beneficiary age for calculating required distributions ("stretch"); however, you do *not* have the option of using the age of each trust beneficiary, because the only beneficiary is the trust.

Instead, assuming the trust qualifies as a "look-through," you must use the life expectancy of the oldest trust beneficiary for required minimum distributions (RMDs). For this reason, anyone naming multiple trust beneficiaries ideally should see that they are close in age. Further, if any of the trust beneficiaries is *not* an individual (e.g., estate, charity), there would be no designated beneficiary for distribution purposes, even if the trust qualifies as a look-through; thus, trust beneficiaries would not be able to stretch post-death RMDs over the life expectancy of the oldest beneficiary. If the trust fails to qualify as a look-through, then it has no life expectancy. Generally, the entire account must be distributed to the trust within five years.

Trust Mechanics: How Do They Work?

When a trust is named as the beneficiary, these are the steps to follow: First, the account should be retitled as an inherited IRA, 401(k), etc. In addition, the account is *not* paid out to the trust. Next, RMDs are made *from* the retirement account *to* the trust. In other words, the RMD is a distribution from the IRA and paid to the trust. Only the RMD amount must be moved, each year, from the IRA to the trust. Distributions are then made to beneficiaries following trust language.

The trustee, assuming trust language permits, can make additional distributions, for example, upon attaining a minimum age, time, and or life event (from the trust) to the beneficiaries of the trust.

Retitling an Inherited IRA

A trust beneficiary should be retitled as follows:

John Smith, IRA (died February 1, 2018)
For the benefit of (FBO) James Smith, Trustee of the Smith Trust, beneficiary

It's imperative that the account is registered using the trust federal identification number—*not* the Social Security of the deceased. Retitling an account incorrectly has severe consequences. Instead of having an inherited account, you will have distribution to the trust, subject to immediate taxation.

Reasons to Name a Trust Beneficiary

An owner of a retirement plan/account has a lot of latitude in naming a beneficiary. He/she could name a spouse, child, grandchild, friend, charity, estate, trust, or some combination. Is a trust, though, right for you? When, then, should someone consider naming a trust beneficiary? Although each family situation is particular to them, fairly common reasons for naming a trust beneficiary include: minors as a beneficiary; a disabled ("special needs") individual; second marriages; creditor protection; estate taxes; or a beneficiary that doesn't have the financial acumen to manage effectively his or her inheritance. In addition, consider naming a trust when the client has beneficiary "trust" concerns—a trust can protect a beneficiary from rapidly depleting an inheritance by including a spendthrift provision. Once again, trusts do not save on taxes; instead, the primary reason to name a trust as beneficiary is to control (post-death) distributions to beneficiaries.

Trust Beneficiary and Taxes

Virtually every trust has its own unique set of rules, and each family has its own dynamics. So, when assessing a trust, consider taking a team approach to designing and implementing it. Involve all centers of influence, such as a tax professional, an attorney, and the trustee, in addition to the client. Notably, a client can make his or her trust as liberal as they want, or conversely, if they want more post-death control, as rigid as they like. It's up to the client—with one caveat: the inherited IRA must pay out at least the required minimum amount (to the trust) annually.

Using a trust to inherit an IRA poses several tax risks if not designed properly. First, the trust could wind up paying higher taxes than heirs would. For example, in 2018, the top trust tax rate of 37% applies to income exceeding $12,500 versus income exceeding $600,000 for married individuals filing jointly ($500,000 for single taxpayers). However, heirs can avoid paying the higher trust tax rate, assuming the trustee can pass all distributions to the trust beneficiary, as opposed to retaining income inside the trust.

The 3.8% investment surtax also needs to be addressed. The surtax applies to taxpayers whose modified adjusted gross income (MAGI) exceeds $200,000 or $250,000 (not indexed to inflation) for married couples filing jointly versus a lower income level for trusts. The threshold for trusts in 2018 is $12,500.

New Tax Brackets Under the Final GOP Tax Plan

Individuals, married filing jointly, trusts and estates

INDIVIDUAL	
Not over $9,525	10% of the taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of the excess over $9,525
Over $38,700 but not over $82,500	$4,453.50 plus 22% of the excess over $38,700
Over $82,500 but not over $157,500	$14,089.50 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$32,089.50 plus 32% of the excess over $157,500
Over $200,000 but not over $500,000	$45,689.50 plus 35% of the excess over $200,000
Over $500,000	$150,689.50 plus 37% of the excess over $500,000

MARRIED FILING JOINTLY	
Not over $19,050	10% of the taxable income
Over $19,050 but not over $77,400	$1,905 plus 12% of the excess over $19,050
Over $77,400 but not over $165,000	$8,907 plus 22% of the excess over $77,400
Over $165,000 but not over $315,000	$28,179 plus 24% of the excess over $165,000
Over $315,000 but not over $400,000	$64,179 plus 32% of the excess over $315,000
Over $400,000 but not over $600,000	$91,379 plus 35% of the excess over $400,000
Over $600,000	$161,379 plus 37% of the excess over $600,000

ESTATES AND TRUSTS	
Not over $2,550	10% of the taxable income
Over $2,550 but not over $9,150	$255 plus 24% of the excess over $2,550
Over $9,150 but not over $12,500	$1,839 plus 35% of the excess over $9,150
Over $12,500	$3,011.50 plus 37% of the excess over $12,500

Source: Joint Explanatory Statement of the Committee of Conference regarding the Tax Cuts and Jobs Act, December 16, 2017; Michael Kitces, **www.kitces.com**

Tip: Periodically review language ensuring the trust continues to meet client objectives. A review is especially important now that tax reform has been implemented.

With some advanced planning, a trust can offer the trustee both the needed flexibility and discretion to decide how much income to distribute to beneficiaries based on their needs, along with how much income will remain after taxes.

Conduit Trust versus Accumulation Trust

A properly drafted trust will not only qualify for "look-through" treatment but also will address whether to be arranged as a *conduit* or *accumulation* trust. A conduit trust serves as a conduit to pass minimum distributions from the inherited IRA to trust beneficiaries. Take the following steps to ensure the distributions are done properly: RMDs should be paid from the inherited IRA to the trust, then from the trust to IRA beneficiaries. Consequently, no minimum distributions (from the inherited IRA) would remain in the trust, which in turn eliminates any trust taxes. Instead, trust beneficiaries would pay tax on distributions (received as K-1 income) at their own *individual* income tax rates.

An accumulation trust (sometimes referred to as a discretionary trust) is generally used by individuals who want full and total control over post-death distributions. Why? An accumulation (as opposed to a conduit) trust does *not* have to pay out all IRA distributions to trust beneficiaries. Instead, the trustee has discretion to either pay out nothing, a portion, or all of the IRA

distributions to trust beneficiaries. But any IRA distribution amounts not paid (to trust beneficiaries) are considered accumulated (in the trust) and taxed at trust tax rates. The trustee can choose to retain annual RMDs in the trust (although RMDs must still be paid from the IRA to the trust), but the trustee is not required make payment to trust beneficiaries.

As noted, a qualifying trust is required to use the life expectancy of the oldest beneficiary to determine annual post-death RMDs. More important, the post-death payout rules for accumulation trusts require using the ages both primary *and* remainder beneficiaries to determine who is the oldest beneficiary. Whereas conduit trusts differ here, only primary beneficiary ages are used to determine post-death RMDs.

Consider Leaving a Roth to a Trust

Inheriting a Roth IRA through a qualifying trust follows the same post-death RMD rules as a traditional IRA—with one significant difference: in the case of a Roth IRA, RMDs generally will be income-tax free—so long as the five-year holding period has been satisfied. Therefore, an accumulation trust that holds a Roth IRA would eliminate the aforementioned trust-tax issues for those situations wherein the trustee decides to retain income in the trust. Roth IRAs also are appealing to those beneficiaries who inherit via a conduit trust. The income paid out via annual distributions also would be free of income taxes. Roth IRA distributions are not taxable, whether they are left to a trust or a person.

If you have any questions about this or another retirement topic, please e-mail me at **roadtoretirement@lordabbett.com**.

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GLOSSARY OF TERMS

Trusts are often written to provide flexible provisions of how trust assets may be distributed.

Traditional IRA contributions plus earnings, interest, dividends, and capital gains may compound tax-deferred until you withdraw them as retirement income. Amounts withdrawn from traditional IRA plans are generally included as taxable income in the year received and may be subject to 10% federal tax penalties if withdrawn prior to age 59½, unless an exception applies.

A **Roth IRA** is a tax-deferred and potentially tax-free savings plan available to all working individuals and their

spouses who meet the IRS income requirements. Distributions, including accumulated earnings, may be made tax-free if the account has been held at least five years and the individual is at least 59½, or if any of the IRS exceptions apply. Contributions to a Roth IRA are not tax deductible, but withdrawals during retirement are generally tax-free.

A **SIMPLE IRA** plan is an IRA-based plan that gives small-business employers a simplified method to make contributions toward their employees' retirement and their own retirement. Under a SIMPLE IRA plan, employees may choose to make salary reduction contributions and the employer makes matching or nonelective contributions. All contributions are made directly to an individual retirement account (IRA) set up for each employee (a SIMPLE IRA). SIMPLE IRA plans are maintained on a calendar-year basis.

A **simplified employee pension plan (SEP IRA)** is a retirement plan specifically designed for self-employed people and small-business owners. When establishing a SEP-IRA plan for your business, you and any eligible employees establish your own separate SEP-IRA; employer contributions are then made into each eligible employee's SEP IRA.

A **401(k)** is a qualified plan established by employers to which eligible employees may make salary deferral (salary reduction) contributions on an aftertax and/or pretax basis. Employers offering a 401(k) plan may make matching or nonelective contributions to the plan on behalf of eligible employees and may also add a profit-sharing feature to the plan. Earnings accrue on a tax-deferred basis.

A **403(b) plan** is a retirement savings plan that allows employees of public schools, nonprofit, and 501(c)(3) tax-exempt organizations to invest on a pretax and or Roth aftertax basis. Contributions to a 403(b) plan are conveniently deducted directly from your paycheck. In addition, your employer may elect to make a contribution on your behalf.

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